

*** Convenience Translation ***

That's why Flatex hovers between 16 and 22 euros

By Stephan Heibel (07.04.2022 12:52)

Darum pendelt flatex zwischen 16 und 22 Euro



Darum pendelt Flatex zwischen 16 und 22 Euro

I have just written a Heibel Ticker PLUS update on Flatex (DE:FTKn) (flatexDEGIRO AG (FTG111)):

"The market is always right" is a popular saying. I have seen too much and therefore know that "the market" - whoever that is supposed to be - is also wrong sometimes. Quite often, in fact. Using Flatex as an example, I have worked out for you in detail how such things can happen.

Perhaps you have already noticed that the Flatex share has been hovering between 16 and 22 euros since last autumn. There is a technical reason why the share does not break out either upwards or downwards. This is not quite simple, but let's take a look at the situation step by step, then it should be understandable.

Through the takeover of DeGiro in the second half of 2020, among other things, a major DeGiro shareholder became a major Flatex shareholder. In the context of such a transaction, the shares of major shareholders are usually subject to a lock-up period, the major shareholder cannot sell its shares for a certain period of time (perhaps one or three years). It is no coincidence that 8.55% of the outstanding Flatex shares have since been hedged with a so-called "collar" (bandwidth).

COLLAR STRUCTURE

"Collar-hedge" in this case means that a Dutch DeGiro shareholder who now suddenly has German Flatex shares in his custody account hedges his new position upwards and downwards. Downwards by buying a put with a certain execution price. Let's say Flatex is hovering around 20 euros. The Dutch shareholder might want to hedge his position at 16 euros. So he buys a put with a strike price of 16 euros. If the price of Flatex falls below 16 euros, the Dutch shareholder has the option of selling his position at 16 euros.

So no matter how low the share should fall, he always gets rid of it at 16 euros.

If the shares do not fall below 16 euros, the put expires. The Dutch shareholder is left with the costs he paid for the put. Depending on the term, this is, for example, about 20 cents per share for one year.

Institutional investors or large shareholders do not like such costs and try to recoup these costs elsewhere. For example, by selling a call on the same position. If a call with a similar maturity and an execution price of 24 euros is sold, this also costs around 20 cents per share. In this transaction, the Dutch major shareholder gets the call cost, as he is the seller.

Thus, the Dutch major shareholder has now knitted a collar: his maximum loss is 4 euros in the event of a price drop from 20 to 16 euros. His maximum profit is also 4 euros in the event of a price rise from 20 to 24 euros. He has covered the costs of the put hedge with the income from the call sale.

SENSE OF THE COLLAR STRUCTURE

You will now ask yourself why a major shareholder sets up such structures. This point was not clear to me either for a long time. The answer that CFO Mo Chahrour gave me is as simple as it is obvious: the share position can be lent at 16 euros per share if such a collar structure is in place. Thanks to this put and call structure, the major shareholder is guaranteed an income of 16 euros per share. So he can use his share position for a loan, e.g. a stock loan, in the amount of 16 euros per share.

Without the collar structure, shares may only be lent at 50%. For the major shareholder, this is a daily changing value that moves according to the price fluctuations of the Flatex share. Something like this brings unrest into an actively managed portfolio that is leveraged by equity loans.

COUNTER-POSITION OF THE BANK

How do I actually know that 8.55% of Flatex shares have such a collar structure? Well, word has got around. The proof comes in a report from Morgan Stanley (NYSE:MS) on 10 March. Morgan Stanley is apparently the bank that facilitates this collar for the major shareholder. Morgan Stanley forms the relevant offsetting positions.

As the relevant reporting thresholds were exceeded in this transaction, Morgan Stanley is disclosing its corresponding offsetting positions. Most recently on 10.3, see here:

<http://irpages2.eqs.com/websites/newsfeed/German/99/detail-page.html?newsID=2212791&companyToken=5700e431-556c-461f-929a-6264211ada76>

There it is stated under item 7.b2 that Morgan Stanley holds call options for 8.55% of the Flatex voting rights as well as 8.55% put options. Under point 10 it is explained that this is a "collar transaction".

The positions were not only built up in March, there are a number of older reports. The news item linked here only reflects the current status.

DELTA-HEDGING

So when Morgan Stanley takes the offsetting position for the major shareholder's collar, the calls are bought and the puts are sold. So now Morgan Stanley has allowed the major shareholder to cap his loss at 4 euros per share, but at the same time the profit is also capped at 4 euros per share. Morgan Stanley now wants to avoid losses as much as possible for the duration of this collar structure. This is called delta hedging. Every price movement that takes place leads to valuation changes. Maybe Morgan Stanley will even manage to make a small profit through proprietary trading.

Now you have to be careful not to get knots in your head.

To understand the following reasoning, we need to make an assumption: The 8.55% of Flatex shares outstanding can be re-placed much more easily at a price of 16 euros than at a price of 24 euros. Consequently, Morgan Stanley will hedge much more when the share price moves towards 24 euros and will reduce this hedge again when the share price falls towards 16 euros.

If the share price now rises towards 24 euros, the call runs the risk of reaching its strike price. At 24 euros, the call that the major shareholder of Flatex sold to Morgan Stanley would mature. Morgan Stanley can then buy shares at 24 euros if the price is above the strike of 24 euros. This is a large amount of shares, after all it concerns 8.55% of the shares of Flatex. At 24 euros, this corresponds to a value of over 200 million euros.

Morgan Stanley will already start selling shares in advance. From Morgan Stanley's point of view, these are short sales, because Morgan Stanley does not yet own the share. The major shareholder has the share and, as part of his collar structure, he has given Morgan Stanley permission to borrow his shares for short selling. The closer the share price gets to 24 euros, the more shares Morgan Stanley will sell short. At some point this will be so many shares that are sold short that the selling pressure created by the short selling will prevent a further rise from Morgan Stanley's point of view if possible.

Conversely, the put would mature when it reaches 16 euros. The major shareholder has bought the put from Morgan Stanley and is thus allowed to sell his shares to Morgan Stanley at the price of 16 euros if the price falls below this.

In this case, Morgan Stanley would also get a large amount of shares in one fell swoop (8.55% of all outstanding Flatex shares). In accordance with our assumption formulated above that the shares are much easier to sell on at 16 euros than at 24 euros, Morgan Stanley will unwind its short position that was built up during the rise towards 24 euros. This creates a trading profit that Morgan Stanley can collect. At the same time, the demand generated by covering the short position will support the price and prevent it from sliding below 16 euros.

So we have a technical limit on the share in the defined range.

WHAT WE KNOW

So much for the theory. So we know that there is such a collar structure. We also know that this structure has a maturity date of 23 September 22. That's in the news item linked above about the Morgan Stanley calls and puts.

However, we do not know what the collar looks like: Were the price marks 16 and 24 euros used? Or maybe 10 and 30 euros? Or 18 and 22 euros? I don't know. At the time of the first report on this issue, the share was trading at around 20 euros, so I assume a symmetrical collar around that price.

We also don't know if at some point Morgan Stanley will have sold enough shares short, i.e. all 8.55% of the outstanding shares, and then not take action on the share's next run towards the upper mark. If so, the stock could break out to the upside.

CONCLUSION

So, that was a bit complex and I hope you took away from it that there are definitely sometimes technical reasons why a share is not "fairly" valued. I am of the opinion that a fair valuation will be significantly higher. There are traders who know about these backgrounds and use the range for their own trades. This then leads to another level of complexity, which I don't want to discuss here now. But I have taken a look at who is currently shorting the Flatex share. At <https://shortsell.nl/short/flatexDEGIRO> you can see that they are exclusively hedge funds that also

speculate on technical market situations. There are no hedge funds taking short positions on conviction against the business model. But of course there are investors who see the fair value for Flatex significantly lower.

For us, this technical fact means that - provided our conviction in Flatex's business model does not crack - we may have to wait a little longer for the share to move towards our fair value level. This doesn't necessarily have to take until September, perhaps Morgan Stanley is already sufficiently short positioned much earlier and then "releases" the price upwards :-)

More updates on Flatex and other interesting stocks are regularly published in the Heibel Ticker market letter.