

## Losing Gamble

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### THE BET

With its stock surging, EDS decided to take a gamble. The company agreed to sell a series of "put options" on its own shares to investment banks. A put gives a buyer the right to sell an asset at a specified price within a limited time. The deals gave the buyers the right to force EDS to buy back the shares at a future date at an average price of \$62.90 apiece -- the "strike price." In exchange, EDS pocketed millions of dollars in fees from the buyers.

EDS was betting that its shares would be above the strike price when the options expired, making them worthless. For EDS, the bet made sense: Its shares had been trading above \$60 for most of 2001, and topped \$70 at the end of the year, when the puts were sold.



### THE RISKS

A sustained drop below the strike price of the puts would mean trouble for EDS, since it could be forced to pay far more for its own shares than they were selling for on the open market. Indeed, in the spring of this year the company's shares began to gyrate, and started to head below \$60.

The contracts in this case were "naked" puts, a riskier strategy because EDS didn't take any steps that would have limited or offset its losses as its stock fell. A sinking share price also meant double trouble for EDS: Not only would the firm be stuck buying shares at inflated prices, the shares it then owned would be worth less and less.



## THE FALLOUT

Over the summer the company's shares slumped as clients US Airways and Worldcom filed for Chapter 11, and dropped further after EDS sharply lowered its third-quarter earnings forecast.

The investment banks forced EDS to cover the contracts as the stock tumbled more than 80% this year, resulting in significant losses for the company. EDS paid a total of about \$325 million to cover its obligations. Accounting for the value of the shares it now owns, EDS said it lost a total of about \$100 million on the bets.

### EDS Bet on Its Stock Price, And Ended Up Losing Big

Ken Brown, *The Wall Street Journal*, September 26, 2002.

Most investors long ago stopped believing that stocks only go up. But two years after the Nasdaq Stock Market collapsed, Electronic Data Systems Corp. apparently still hadn't gotten that message.

In the midst of the bear market late last year and through this spring, the big computer-services company cut a series of deals with Wall Street investment bankers that, in effect, were bets that its stock would continue to rise. The deals ultimately obligated EDS to, in effect, buy back a total of 5.44 million shares, including a big slug Friday with a \$225 million price tag.

The Friday shopping trip cost the company about \$60 a share, though the company's stock was trading on the New York Stock Exchange at a mere \$17. The stock is down 32% this week, despite a gain Wednesday of 47 cents to \$12.15 in 4 p.m. Big Board composite trading.

How did EDS wind up in this situation? Numerous details of the gambits remain unclear. But at the heart are a series of complicated transactions involving two different financial products, twinned together: One is a "forward purchase agreement" in which EDS committed to paying a set price, that ultimately averaged \$61.58, while the other is a "put" option, that gave the buyer of those options the right to sell a specified number of shares to EDS for a price that ultimately averaged about \$62.90.

Why bother with such deals?

EDS's objective was simple: to buy back large amounts of its own stock, at a fixed price. The reason: to avoid diluting the pool of stock in issue as employees or investors exercised stock options. A stock option is a kind of instrument that allows its holder to buy stock at a fixed price. Many companies offer them as a form of compensation.

EDS knew roughly how many stock options its employees or investors could choose to exercise. It also knew that if they were all exercised and the company simply issued new stock, the number of

EDS shares would increase. Each share already outstanding would therefore get a smaller piece of EDS's earnings. To avoid that phenomenon, known as dilution, the company decided to buy back shares from the market in order to distribute to employees who were exercising options.

EDS executives wanted to lock in what they would pay for enough stock. So they arranged the transactions with their bankers. In them, they agreed on a price they were willing to pay, regardless of the direction the market took. The bankers then built the structures that would ensure EDS would be able, or have to, buy the shares at that price.

Beginning last year, EDS struck the first of the transactions, to lock in a share price on 1.36 million shares. The deals were detailed in largely overlooked footnotes to its 2001 annual report filed in the spring. In the initial transaction, known as a forward purchase agreement, it made a deal to buy, at an unspecified date in the future, 539,000 shares of its stock at a set price of \$70.14 each. A special feature of the contract, known as a collar, limited the amount of profit EDS could make if the market price of the stock was higher than that when the transaction was settled.

At the same time, it agreed it would buy an additional 821,000 shares from its bankers for \$70.73, if they wished to sell more stock to EDS. If the market price was above that level, the bankers presumably wouldn't exercise the contract, known as a "put," but they agreed to pay EDS a fee of about 75 cents a share if the contract expired unused. If the price of the stock fell below that level, which it eventually did, EDS would have to buy the stock at the agreed-upon higher price, and the bankers would profit. (The options are called puts because the buyer is obtaining the right to put the contract back to the seller, forcing the deal.)

Throughout the first half of this year -- with its stock dropping steadily from a high set late last year -- EDS dramatically boosted the number of shares it committed to buying under the deals, to a total of 5.44 million, according to EDS executives.

Because the share price was down, and because EDS reached additional agreements to buy so many more shares, the average price it was required to pay for the shares fell to \$61.58 for the forward purchase agreements and \$62.90 for the put options.

The upshot: The company's treasury got the benefit of stability, knowing it would pay a set price a share for stock it would need to fulfill its obligations to employees exercising stock options, without the need to issue new shares that would dilute the amount of stock in issue.

"It's an attempt by companies to inject certainty into cash and capital needs," says EDS Treasurer Scott Krenz. "You don't want variability. You want to lock in a price."

The company stopped striking these agreements in May just before its stock tumbled on fears that it would be hurt by the bankruptcy-court filing of WorldCom Inc., a big customer of EDS's information-technology outsourcing business. For EDS, the 80% drop in its stock price this year caused its strategy to backfire badly.

In retrospect, the two different deals appear to be nothing more than a speculative bet by the company on its own stock, some analysts say. The timing of the deals that EDS cut "is curious," given how long and deep the bear market was at the time, says Merrill Lynch analyst Stephen McClellan, who revealed EDS's transactions in a note Tuesday in which he lowered his rating on the company to "sell."

And with its stock sinking earlier this year, EDS started buying the shares at the agreed-upon prices, initially purchasing 1.7 million. Then last week, EDS shocked investors when it said its profit for the

current quarter would be a fifth of what it had promised just a few weeks before. Investors sliced the stock in half, pushing it down to the upper teens.

That steep slide triggered a provision in the contracts calling upon EDS to make good on its commitments if the shares fell 50%. On Friday, EDS borrowed \$225 million to buy in the remaining 3.7 million shares. The company didn't disclose the move. EDS executives since have defended their silence by maintaining that it wasn't a material event because it wouldn't affect earnings.

So how did EDS's \$225 million contract settlement surface? Analysts at two securities firms, Merrill and Banc of America Securities, decided after the company's profit warning to go dig into EDS's filings and they ran across the obligations. They called company executives, who acknowledged the share purchases.

Now, as it turns out, not only did EDS pay way over the asking price for its own stock, but it sent valuable cash out the door to do so. And because EDS's shares have sunk so low -- they are now trading where they did in the spring of 1989 -- few employees will be able to exercise stock options this year, making the whole point of the share-buyback moot.

All told, EDS estimates it lost about \$100 million on the bets. Here's how it figures: It paid a total of about \$325 million to cover its obligations, including the \$225 million it paid last Friday and about \$100 million for the shares purchased earlier this year. But EDS expects those shares ultimately to come in handy, either to cover debt that could be converted into shares in the next few years or to offset dilution from future stock-option exercises.

Accounting rules say that the \$225 million sent out the door to cover the buybacks won't technically cut EDS's earnings, because the transaction isn't run through the income statement; transactions involving a company's stock generally wouldn't show up on an income statement. However, because EDS borrowed the money, there is an interest expense that will bite into earnings a bit. Meanwhile, the cost of buying the shares will show up on the company's cash-flow statement under the line for "cash flow from financing activities." Another impact: less cash on the balance sheet of a capital-intensive company that is struggling to generate cash from its operations.