How EDS Rolled Dice—and Lost

Effort to Prevent Option Grants From Diluting Per-Share Profit Backfires When Stock Plummets

By Ken Brown

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.

The big computer-services company, like a high roller in Las Vegas ignoring the risks, rolled the dice in a big way. In the midst of the bear market late last year and through this spring, EDS cut a series of deals with Wall Street investment banks that would obligate it to later buy back its own shares—at the price on the day the deals were struck.

So if EDS's shares, which were trading around $60 when the deals were made, rose back to their high of $70, EDS would have been able to buy shares at $60, getting itself a bargain. Indeed, in one transaction, EDS raked in a couple million dollars for its trouble.

But there was one problem: The deals didn't protect the firm in case its stock dropped. And now EDS's bet has come up snake eyes.

EDS ultimately did, in effect, buy back the shares covered by the deals, 5.44 million altogether, fulfilling the obligation it had made just months before to pay about $60 apiece. Under pressure of the equivalent of a margin call, the most-recent purchase came on Friday. Since EDS stock was trading last week at a mere $17, this final purchase of 3.7 million shares ended up costing EDS $225 million.

The stock has been hammered—down 32% this week, despite a gain yesterday of 47 cents to $12.15 in 4 p.m. New York Stock Exchange composite trading.

The "timing is curious" of the deals that EDS cut, 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 on Tuesday in which he lowered his rating on the company to "sell."

So how could a major company with a sophisticated corporate-finance department make a mistake that most high-school investment clubs would have avoided?

It all goes back to stock options, the form of compensation that grew increasingly popular during the raging bull market. When employees exercise their stock options, companies must issue shares. But all those new shares reduce the amount a company earns per share, which can hurt the stock price. So companies often buy back shares of their own stock to offset the impact of shares issued when employees exercise options.

Doing this invariably costs the company money because employees exercise their options only when the stock's market price is higher than the exercise price of the options. For example, if the average exercise price at which employees buy shares is $20 and the company—to avoid dilution—buys back the same amount of shares at an average market price of $35, the effective cost to the company is the difference of $15 a share. If the stock had risen to $75, the cost to the company of buying back shares would be a steep $55 a share.

Indeed, this was the scenario facing many companies when stock prices were rising sharply in the late 1990s. While these costs couldn't be totally eliminated, companies began looking for ways to put a cap on them. So dozens, including Dell Com-

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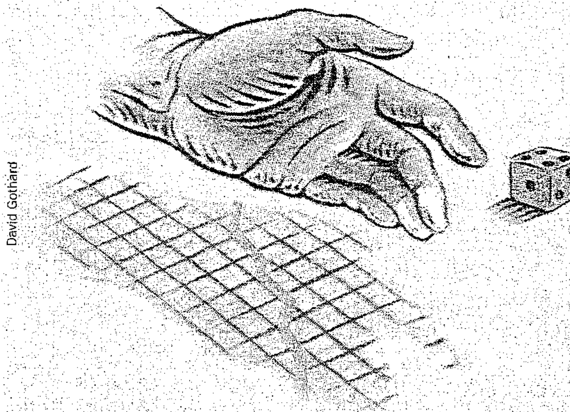
Journal Link: *See an infographic showing how EDS's strategy to sell put options on its stock backfired, in the Online Journal at* **WSJ.com/JournalLinks**.



A Bad Bet On Its Own Stock

At the end of 2001, EDS planned to buy back millions of shares of its own stock to offset shares that it expected to issue to employees who exercised their stock options. But it was afraid its share price, which had held up well in the bear market, would keep rising, making those buybacks expensive. So it cut deals to protect it from a rise, but it never thought its shares would collapse like they did.

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Daily closing share price

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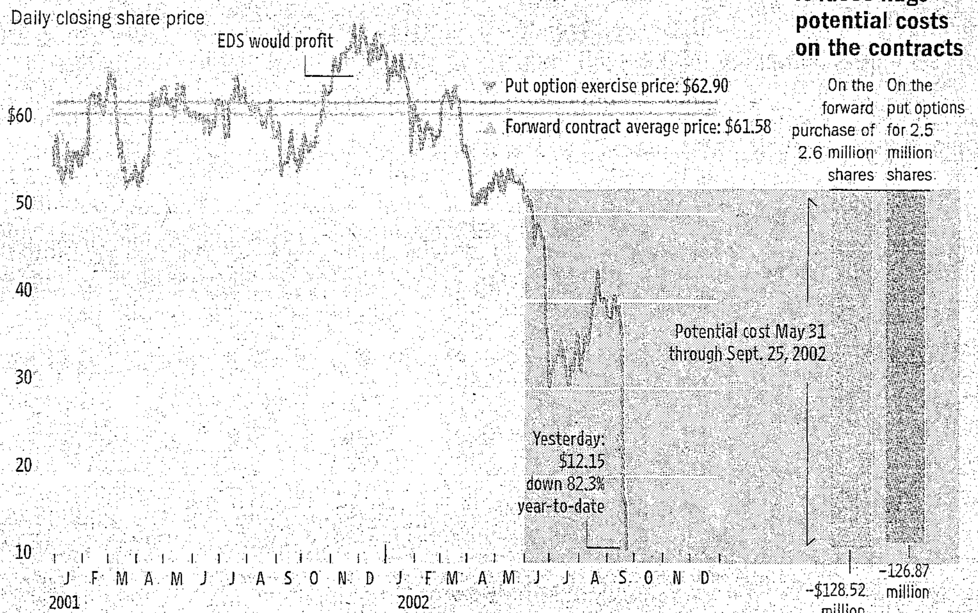
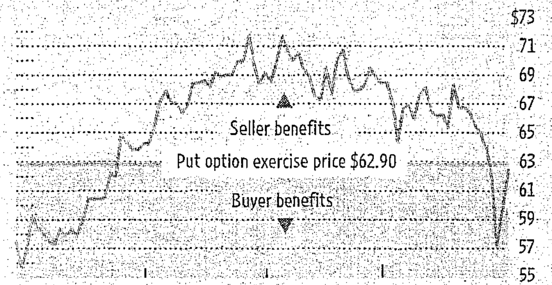


The put option: How it worked

The put options gave buyers of the option the right to sell EDS, the writer of the options, as many as 2.5 million shares of its stock at a $62.90 before the options expired.

The purchaser of the put option would pay EDS a premium for the right to sell those shares. If the buyer exercised the put, EDS would have to buy the shares, which closed yesterday at $12.15, for $62.90. EDS was hoping that its shares went up in value, so they could keep the premium they'd collected and not have to lay out any money.



Sources: Thomson Datastream; the company

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puter Corp. and Microsoft Corp., used "put" options and other financial-market strategies to lock in the prices at which they would buy back their shares.

For EDS, the 80% drop in its stock price this year caused its strategy to backfire badly. Executives at EDS say that the company was trying to fix a price for the shares it expected to buy back this year. "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."

Here's what happened:

Last year, EDS struck two different types of deals 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 first, called 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, regardless of the stock's price in the market on that unspecified future date.

It also sold "put" options on 821,000 shares, which gave the buyer of those options the right to sell that number of shares to EDS for $70.73 a share, also regardless of the stock's price in the market. (The options are called "puts" because the buyer is obtaining the right to "put" the contract back to the seller, forcing the deal.)

Then, 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, to a total of 5.44 million, according to EDS executives.

Because the share price was down, and because EDS reached 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: No matter which way EDS's share price moved, the company knew exactly what it would pay to buy back those shares: an average of $61.58 apiece for the first lot, and $62.90 for the second.

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., which was a big customer of EDS's information-technology outsourcing business.

The two different deals appeared to be nothing more than a speculative bet by the company on its own stock, some analysts say. Others on Wall Street suggest that EDS executives might have believed its shares had gotten so cheap that they were a bargain at that price, and that is why they boosted their commitment to buy shares. EDS says it was simply trying to get a handle on its costs for the year ahead and had expected many employees to exercise options.

Either way, EDS, with its stock sinking early this year, decided to start buying the shares at the agreed-upon prices, eventually purchasing 1.7 million. Then last week, EDS shocked investors when it said its profits 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 by 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.

To say the strategy backfired is an understatement. 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.

—Elliot Spagat contributed to this article.

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