OPTIONS PUT GIANTS IN A JAM

For years, companies made billions on investor bets that their stocks would fall. Soon, they may owe billions

In the great bull market of the 1990s, many companies thought they were printing money by selling options on their own stock. Microsoft Corp. made about $1.8 billion in the three years ended last June by selling puts to investors who bet that Microsoft's stock would decline. As the stock rose, the puts expired worthless. Over the same period, Dell Computer Corp. reaped $97.5 million selling puts on its stock. Even Adaptec Inc., a small manufacturer of computer peripherals, made about $13 million.

"This strategy makes all the sense in the world for successful technology companies," Gregory B. Maffei, Microsoft's former chief financial officer, told BUSINESS WEEK in February, 1998. Boy, was he wrong. If Microsoft's current put options were to expire today at its Jan. 2 stock price of $43.38 (their actual expiration dates run to March, 2003), it would end up costing the company $4.8 billion. For Dell, the hit would be $3.4 billion, and for Adaptec, $72 million.

Even nontech companies have been selling puts. But not all are hurting as badly. McDonald's Corp. gained $126 million in three years before the market soured. Its potential loss now is $61 million. But then, its share price has fallen only 17% in the past year.

To be sure, these companies' put options expire over one to three years, which means the companies are unlikely to make one huge lump payment in any given quarter. But the longer their stocks remain depressed, the more these puts become a burden. "Microsoft, Dell, and Adaptec are some of the most aggressive companies with regard to the use of options," says Bob Gabele, director of insider research at First Call/Thomson Financial. "This is the other side of the option game. There can be a hidden cost to corporations with aggressive option programs."

Big institutional investors, including such otherwise conservative players as foundations and college endowment trusts, have long fattened their returns by selling puts and calls against their huge stock positions. And some companies have sold modest amounts of puts against their own shares for at least two decades. But many more jumped into the game in a big way in the late 1990s. Now, these put sales may turn into a huge drain on cash or may cause dilution of earnings per share.

A put option is a bet that the company's stock will decline below a certain price. In the bull market, when the mere announcement of a buyback program propelled companies' stocks ever higher, most puts expired worthless and the companies just pocketed the proceeds from put sales or used the extra money to offset the cost of buying back their shares. The typical buyers of the puts were big investment banks.

TAX-FREE. An added appeal of selling put options is that companies take tax free gains on their balance sheets instead of on their profit-and-loss statements. Gains and losses are reported as changes in stockholders' equity, not net income.

But as stock prices have tanked, companies that aggressively sold puts now find themselves on the hook, owing lots of either cash or stock to pay off the holders of the puts. In a typical transaction, an investor might buy a put option with a strike price of $100. If the stock falls to $50, the issuing corporation must buy shares from the investor, at $100. Alternatively, the put contract can be settled without a share buyback. In this case, the company pays out the $50 difference between the put's exercise price and the shares' market value. It can do so either by paying cash or by giving the investor a share to sell in the market. Either way, the company is out $50.

PLAYING THE PUT GAME

SELLING PUTS

Company A is very bullish on its stock and decides to sell put options to earn extra cash.

The puts give the buyer the right to sell the stock back to the company at a specific price within a specified time period, say, one year.

Company A's stock trades at $100 a share. It sells puts, exercisable at $100 a share, on 1 million shares.

To buy the puts, an investor pays a premium of, say, $10 a share. The company pockets a total of $10 million in premiums.

EXERCISING PUTS

A year later, if the stock price is at $100 or higher, the puts expire worthless. Company A has made $10 million.

But suppose the stock falls to $50. The investor can buy shares at $50 and exercise the puts, requiring Company A to buy back the shares at $100. In this case, the company loses $50 million, minus its $10 million in premiums. So its net loss is $40 million.

Often, though, puts are settled without a buyback; the company just pays the $50 difference between exercise price and market value. In this case, the company can pay the difference by giving the put holder a share worth $50. That increases its shares outstanding and dilutes earnings per share.

Company	Gains	Potential losses**
Microsoft	GAINS 1997-2000*: $1.8 BILLION	$4.8 BILLION
Dell	GAINS 1997-1999*: $97 MILLION	$3.4 BILLION
McDonald's	GAINS 1997-1999*: $126 MILLION	$61 MILLION

Microsoft: *AS OF 6/00
Dell: *AS OF 10/00
McDonald's: * THROUGH 12/99

** TO THE BALANCE SHEET. ALL CALCULATIONS BASED ON AVERAGE STRIKE PRICE AND CLOSING STOCK PRICE THROUGH 01/02/01 AND NUMBER OF PUTS OUTSTANDING

SOURCE: SEC FILINGS AND SCA CONSULTING

"All of a sudden, these companies have to make good on puts, where in the past, they've just been on a gravy train. It was purely money for their coffers," says Abe Mastbaum, a man-

aging director at American Securities Capital Partners LP, a New York money-management firm.

Some companies will be hit harder than, others. Adaptec Inc. sold options on more than 2 million shares in 2000 with strike prices of $23 and $43. Execs at Adaptec have watched their shares decline by 80% in the past year, to about $10. If the company had to make good on all these put options today, it would cost $72 million.

Puts could cost Dell 35 times as much as it made on the options in the past three years

But Adaptec, like many other companies that issued puts, has the right to settle its put contracts by paying back investors with shares rather than cash. Still, the price could be dear. If all of Adaptec's outstanding put options expired today, the company would have to deliver more than 7 million shares to put holders. According to New York's SCA Consulting, which advises companies on ways to increase shareholder value, that additional stock could dilute Adaptec's earnings per share by about 7%. David A. Young, Adaptec's chief financial officer, says some of the company's puts were exercised last quarter at a cost to the company. But he won't give financial details in advance of Adaptec's upcoming quarterly report.

"These guys thought buying their own shares at $44 was a good deal," says a money manager who asked not to be named. "Instead, they're being forced to issue more shares at $8. When I went to school, it was buy low, sell high—not the opposite."

Microsoft's Potential $4.8 billion negative exposure is almost three times what it has made selling puts since 1997, while Dell's put program stands a chance of costing it 35 times as much as it has made on puts in the past three years. Both companies point out that the put options they have outstanding now will expire over the next three years, so they won't have to take the hit all at once. Dell execs say they will pay their obligation in cash, not shares, and Dell spokesman T. R. Reid notes that the company has generated $800 million to $1 billion in cash in recent quarters. Still, its potential $3.4 billion loss represents about 73% of its cash on hand at the end of the third quarter.

Despite the big potential losses, some investment bankers defend corporate put programs as an excellent way to buy back shares. "The sale of puts allows companies to be paid for committing to buy back stock," says Chris Innes, a managing director at Banc of America Securities in New York.

LUCKY OR PRESCIENT? Some companies have stopped their put programs completely, even though they've continued their buybacks. Intel Corp. made $348 million over three years selling puts. But Intel's board turned conservative in mid-1999 and called "a halt to the program," says Chuck Mulloy, a company spokesman. Intel was either lucky or prescient: Its stock price has fallen by nearly half since March.

The decision to sell puts may turn out to be most dangerous for small companies, says Jeffrey W. Joyce, a senior associate at SCA Consulting. "The impact of Adaptec's put program will be far more dilutive, at 7%, than Microsoft's, which could be diluted by only 2%," he says. It's conceivable, Joyce adds, that an aggressive put program could create significant financial problems for smaller companies with poor stock performance. "The moral of the story is: The bigger you are and the better stock performance you have, the less impact this has on you."

That may be so. But for now, the days of easy money from sales of put options have gone the way of the Gutenberg printing press. They're history.

By Debra Sparks in New York

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