Playing a Takeover

Care must be taken when analyzing takeover opportunities

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An enormous amount of options activity accompanies takeovers and takeover rumors, and these can be gold mines of opportunity. Yet you must be careful. One way to play takeovers is to bet on the price. If you want to play it to the upside (as these things often *do* go much higher after the initial news or rumor), you can pick a call to purchase, or open a vertical debit spread in calls or a vertical credit spread in puts.

Or, you can use some good analysis tools and do some volatility-based trading. This approach can be very safe and lucrative. Returns are more predictable, as you do not have to guess the direction of the underlying security. Volatility-based trading does, however, require some finesse. Playing a takeover is like flying your plane through a storm. The figures can lie. What seems like an opportunity may not be. You have to be careful interpreting the numbers.

A good example was RJ Reynolds, when it was waiting for a Nabisco shareholder vote about its being acquired. In anticipation of this vote, Nabisco's nearby options were inflated to higher premiums than its farther-out options. For example, the October calls were trading at an implied volatility of 37%, while the December calls were trading at only about 18%. A similar differential existed in the puts.

This automatically suggests opening a horizontal debit spread, selling the more expensive nearby options and buying the cheaper farther-out options. But before rushing in, you ought to stop and ask yourself "Why are these options being priced this way?" Search for some logic that would explain what you are seeing.

In Nabisco, traders were giving the nearby options higher premiums because, if something is going to happen with Nabisco, it's going to happen very soon or not at all. The expected near-term price volatility in Nabisco translates into a higher volatility for the period from now to expiration of the October options than for the period from now to expiration of the December options.

As you may know, horizontal debit spreads have "the life squeezed out of them" when the price of the underlying moves much higher or much lower. Therefore, if you were to take a horizontal debit spread in Nabisco, you would be accepting the better odds (the apparent bargain) to bet on Nabisco staying about the same price, against those who were accepting worse odds to bet on Nabisco taking a big jump. Are the horizontal debit spreads such a bargain after all? Maybe not.

Big differences between put and call implied volatilities can also occur. In the old RJR takeover situation several years ago, there was to be a large dividend payout. As you know, a dividend causes the stock price to drop the day the stock goes "ex-div". In this case the dividend was to be so large that all the puts seemed extraordinarily overpriced and all the calls were "flat". Naively selling the expensive puts might have been ruinous if it weren't for the fact that RJR stock continued higher. Finding out about such a dividend, you would enter it into your option pricing model. As soon as you did, the calls and puts would seem to be more normally priced.

Another example was when Cendant offered to purchase all the outstanding shares of Avis that it did not already own, at a price of $29 per share in cash. Avis hired a firm to advise it on the Cendant proposal, as well as other strategic alternatives available to the company. That gave Avis stock has an apparent floor at $29 and the potential to go higher than its price of 30.5 at the time. Then the Avis March 35 calls (IV=18%) were undervalued in relation to other Avis call options, and could have been bought. Or, the December 25 puts are overvalued (IV=55%) and might be sold naked.

Takeovers can be profitable – just be shrewd. Don't be naïve in how you read the numbers. If you see something strange, try to figure out why it is that way. Read everything about the situation. Dig into the arithmetic of the deal and learn of any ratios that may apply. Then, once you're sure, act fast! Option trading opportunities in takeovers can come and go quickly.