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How I’m playing the Twitter arb now

JULY 12, 2022 / PUPPYEH / EDIT

I have purposefully avoided discussing Elon Musk’s Twitter purchase on this blog, until now. Part of this hesitation was the desire to wait until all the ‘bad news’ was out, as Elon’s **formal attempt to terminate** was somewhat (if not overwhelmingly) likely for many weeks now. Another part of this heretofore reticence was my view that I had very little additive to say: this story has been very well covered by other special situations guys (see my friend Andrew Walker’s write-up, **here**, which I consider one of the best pieces he has written and one of the definitive takes on the topic; and of course Matt Levine at Bloomberg Money is consistently excellent and ‘on the money’ (haha), especially with his coverage of this **circus**). Thus I only really wanted to contribute to the discussion when I had something to add – and most importantly, for subscribers, an actionable, interesting, trade to monetize to the situation. That is where I think we are, today.

I should start by saying, with the formal termination notice, this situation has become a ‘legal’ bet, where we are speculating on the outcome (or the negotiation informed by the parties’ views of the outcome) of a court case. That is certainly not for everyone, and definitely not one I would normally gravitate towards. But most all good event investing is, perhaps, pattern recognition colored by the reality that every situation is somewhat unique; that is, a combination of extrapolating from similar events and outcomes in the past, overlaid against recognizing what is different, and what is important, this time around. And at its most basic level, I believe TWTR stock price (at sub-\$33 today) is badly mischaracterizing the likely outcomes of the pending legal

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case. We can structure a most interesting trade to profit from the market's correction of its view, as the case develops.

First though we need to understand, what exactly is Musk's argument; and what must he prove in court to get out of the signed, sealed, and delivered, Merger Agreement. You can read the full text of Elon's lawyer's letter [here](#), but essentially there are four reasons given for why Musk has the right to terminate:

- Twitter has been lying about the prevalence of fake accounts ('bots') on its platform, for years, and this constitutes 'materially inaccurate representations' about its business, triggering a 'reps and warranties' breach of the Merger Agreement;
- Twitter's lies about said fake accounts may 'reasonably be likely to have caused a Company Material Adverse Effect', allowing Musk out of the deal;
- Irrespective of these two breaches, Twitter has not complied with the information disclosure and sharing requirements embedded in the MA, specifically Section 6.4, which enjoins Twitter to provide all data and information that Musk requests 'for any reasonable business purpose related to the consummation of the transaction';
- Finally, Twitter has breached a separate clause of the agreement (Section 6.1) – the commitment to 'preserve substantially intact the material components of its current business organization' when they let go of a couple of executives and cut 1/3 of the a sub section of the company.

It is worth noting that by far the majority of said attorney's letter – perhaps two-thirds of the ink spilled – deals specifically with the information sharing around the purported bot issue – not the bot issue's materiality itself. Let's keep that in mind as we consider some of the particulars.

Matt Levine, in his inestimable style, has already given short shrift to many of these arguments, and others have documented how patently ridiculous some of these claims are. The Material Adverse Effect claim, in particular, stands out. It is well understood in precedent law how almost impossibly tough the MAE standard is in a legal setting – as my friend Andrew has alluded to, the [Alere/Abbott case](#) in particular where basically operational fraud was proven, and yet there was no adjudicated MAE/MAC in the eyes of the court. Forget the idea that Elon waived due diligence, and that the bot issue was the very reason why he wanted to buy Twitter in the first place (to fix it); from a pure legalistic perspective, Elon would have to prove, somehow, not only that Twitter was lying about the bot issue – *but that said lying damaged the business in a material way* (call it a permanent 40-50% reduction in earnings versus some pre-determined prior earnings base). I am not sure how that is even an issue worth considering given that the bots disclosures (in Twitter's filings) haven't changed in many years; and that advertisers still get the IRRs that they currently do – even if the bot number is, and has been, actually wildly understated. Of course – there is no evidence presented for this view, it is simply stated as a 'belief' of Mr Musk. So color me unconvinced on this particular point.

Some of the other 'outs' appear to have more legs initially but on second glance appear almost as ridiculous. The contractual proscription for Twitter to give Elon access to

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information is plainly – and this is not debatable – only limited to ‘for any reasonable business purpose related to the consummation of the transaction.’ Elon has made it abundantly clear (on Twitter, of all places), that he is simply seeking the information by which he can destroy the deal, not consummate it; and as such Twitter is actually abiding by the contract when they refuse to grant information that could potentially lead to such a purpose. Moreover there are other clauses that protect them in this regard (competitive secrets, etc), as well, even if the limited purpose for which they are bound to share information didn't. I simply don't see any reasonable judge looking at this fact pattern – and remember Twitter did not totally stonewall Musk, they just didn't give him all the keys to the kingdom, apparently – and decide Twitter has withheld ‘material’ information necessary to close the transaction.

That leaves the final breach, as claimed by Musk: the idea that Twitter was not operating in the ‘ordinary course’ when it fired a couple of executives and laid off some of its talent team members. This potential breach is given a grand total of four lines at the end of the lawyers' letter, so it seems merely a throw-away, but perhaps there is at least some skerrick of a chance Musk could wriggle out here – even though, again, the contract language states that Twitter must ‘substantially’ preserve the ‘material’ components of its organization. It would be a huge stretch to suggest the minimal restructuring done thus far would violate either of those provisos, in my view.

What actually happens? What does ‘winning’ look like for Twitter shareholders?

It seems to me, then, that Twitter's legal position is basically inviolate – or, to be more nuanced, *as inviolate as it is possible for these things to ever be, cognizant of the inherent risks and uncertainties of any legal proceedings*. I am extremely confident, if or when this ‘case’ actually gets litigated, that Twitter will win, and win handily – to me that is not where the real uncertainty lies. Instead it lies in the shape and ultimate form of legal victory, or any potential settlement (which would be informed by all this reasoning).

If we were to assume, reasonably, that Twitter has a very, very strong legal case, we would then need to understand what they would be in line to receive if they win. Of course they are suing for ‘specific performance’ – that is, the Court to force Musk to complete the merger on said terms and thus purchase at \$54.2 – but the judge is under no obligation to grant that. The judge could grant specific performance; or he/she could (and perhaps is more likely to) grant monetary damages, in some form, up to (or I suppose, above) the theoretical damages caused by Musk's withdrawal (this number would need to be calculated of course); or the judge could simply decide on a much lower number that he/she deems is ‘fair’.

To me this is where the principal risk in this trade lies: the judge rules for Twitter but does NOT force specific performance on Musk because doing so would be too painful for all involved – Musk; Twitter as an organization; the banks, etc – and instead of awarding true damages (meaning some amount of money being the difference between \$54.2 per share and whatever a reasonable break price may be, say \$25 per share) instead awards a token, but still largely insufficient amount, call it \$5-10 billion dollars (ie \$7-13/share).

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To be clear: I think Twitter has an impeccable legal case AND a very strong chance at extracting specific performance. It is worth examining, I believe, the Judge's opinion in **IBP Inc vs Tyson Foods (2001)**, the last Delaware case here in which specific performance was awarded to the plaintiff. In that case, after some agonizing, the judge decided upon forcing the buyer to complete the deal, for a variety of reasons but principally because *'such an award is decisively preferable to a vague and imprecise damages remedy that cannot adequately remedy the damage to IBP's shareholders'* (note: it is well worth reading the entire Opinion, but if not that, at least section IV dealing with specific performance, in the above link).

What would Twitter have to demonstrate to get specific performance, then? Principally that it is either very difficult to measure precise damages monetarily; and/or that the true monetary damage number is so large as to make specific performance preferable for the buyer. Both of these things, to my mind, seem reasonably true. No one really knows where Twitter stock price would trade if the deal totally breaks: even today, one analyst is saying Twitter would be worth **only \$11/share**; whilst others seem to think \$25/share is the right number. But these are just static, 'mark-to-market' assessments looking at related businesses' equity movements since the Musk bid was first tabled – we must not forget that Musk himself has caused huge reputational and actual damage to the organization (rubbishing its mDAU calculations, claiming Twitter is committing securities fraud in its reporting re the bot issue; saying he is going to fire everyone and thus encourage a ton of employees to quit, etc) that will be difficult to quantify in dollars. And if we were to attempt to put a \$ number on the true damage to Twitter stockholders if Musk walked, then the difference between \$54.2 and say even \$30 – a most optimistic assessment of the break price – is still about \$18bn in total value. No doubt at that level of monetary damages Musk would probably rather own Twitter at the original deal price, if given such a choice.

Both of these considerations would, to me, support the idea that specific performance is the right remedy and really the only proper one in this case. Against this, the judge would have to weigh the ostensible reality that Musk would be an unwilling buyer; and that the banks would likely be unwilling financiers (though contractually bound). He may then simply decide to offer not full monetary value, but something more 'palatable' – say \$10bn? – even if this did not meet the needs of us, the suffering Twitter shareholders. That is where the risk really lies. All of this of course affects not just the likely court case, but discussions for a settlement around the court case which must be ongoing concurrently.

If I were to summarize, then, my thinking on matter, it would be this: Twitter has an almost-inviolable legal position, according to the actual contract; and a strong case to get exactly what it is asking for (even if the strength of the 'ask' is nowhere near as strong as the legal position itself). *But there remains considerable downside even in the case where Twitter wins* because getting what it wants and is perhaps entitled to is certainly fraught with more risk than simply winning on the merits. Lawsuits are not like running races: you can cross the line first and only then be told what the prize is, perhaps to your chagrin. And because all parties know this, they may end up settling before we even get to court for something less than what I would consider satisfactory.

 June 2020 (6)

 May 2020 (7)

 April 2020 (5)

 March 2020 (4)

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 December 2019 (2)

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 August 2019 (2)

 July 2019 (3)

 April 2019 (1)

 March 2019 (3)

 July 2016 (1)

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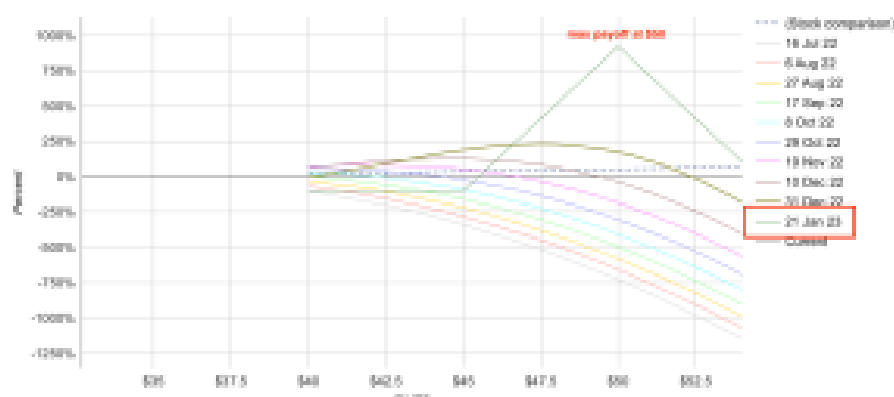
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Structuring the trade: 6mo 1×2 call spreads, 45/50 strikes

That is why I am placing my bets here in a rather nuanced fashion – using **1×2 call spreads**. In this case I have selected **January'23 expiry** – about six months from the current, as based on past precedent this timeline will most likely cover anything but a most extended court battle, assuming Twitter is granted an expedited trial (which my research suggests is overwhelmingly likely). I paid **45c for the \$45/50 1×2**, net, meaning my break-evens would be \$45.45 on the lower end (ie Twitter stock needs to be above that level for me to make money); the max payoff is at \$50/share, and is **basically 9x at \$50/share** (ie under the assumption Twitter cuts a discount to the actual agreed deal price); and importantly even if the deal closes at original terms the trade will still be profitable. Here is a schematic showing the payoff (you can calculate your own, for free, [here](#)):



You can perhaps implicitly understand the attractions of this structure: we are risking a very low amount of premium – under 50c a share – to make a larger structured bet on Twitter not only prevailing in court but extracting something quite close to the original deal terms. Even if Twitter somehow agreed to a most substantial cut (but still closed the deal) in the \$45-50 range, this trade would be solidly profitable; on the other hand, if it all goes pear-shaped and Elon somehow prevails, we really don't lose a whole lot (just our original net premium of 45c). On the other hand, if the case were to be resolved with a smaller-than-expected cash settlement (say \$5bn or \$7bn), I imagine this trade would end firmly out of the money even if Twitter stock recovered somewhat from current levels. I do not think this will happen, and would consider such an outcome a mistake in my analysis – and thus I would have to simply take the loss under this structure. But this is the key risk and I am comfortable with it. As a result I am **adding** this derivatives bet to the book.

Disclosure: long TWTR stock and Jan'23 \$45/50 1×2 call spreads

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