

## Derivatives Strategy

November 16, 2009

### Take a Ride with CAR

Get Long Stock Against Selling May 2010 7.5/12.5 Strangles

**Avis Budget Group is positioned for earnings growth into 2010 driven by a strong pricing environment amidst tight vehicle inventories and stabilizing demand. Positive pricing data points will catalyze the stock in coming months, and with volatility rich we recommend initiating long positions against selling strangles.**

In our recent note **“Momentum Ahead of the Fed”** we discussed the historic equity market outperformance into Fed tightening cycles and highlighted semiconductors and consumer services as two industry groups poised to rally through mid-2010. Avis Budget Group (CAR, Buy Rated, \$18 target) typifies a consumer service company that should benefit as the economy recovers from recession, and we expect the stock to participate in the broader group’s outperformance. Positive data points on the rental car pricing environment over the next several months will lead into a F4Q09 earnings report that we believe will demonstrate the company’s increased operating leverage. We recommend initiating long stock positions in CAR and taking advantage of rich volatility to sell strangles.

**CAR is positioned for significant earnings growth over the next two years with EPS rising from a loss of (\$0.01)**

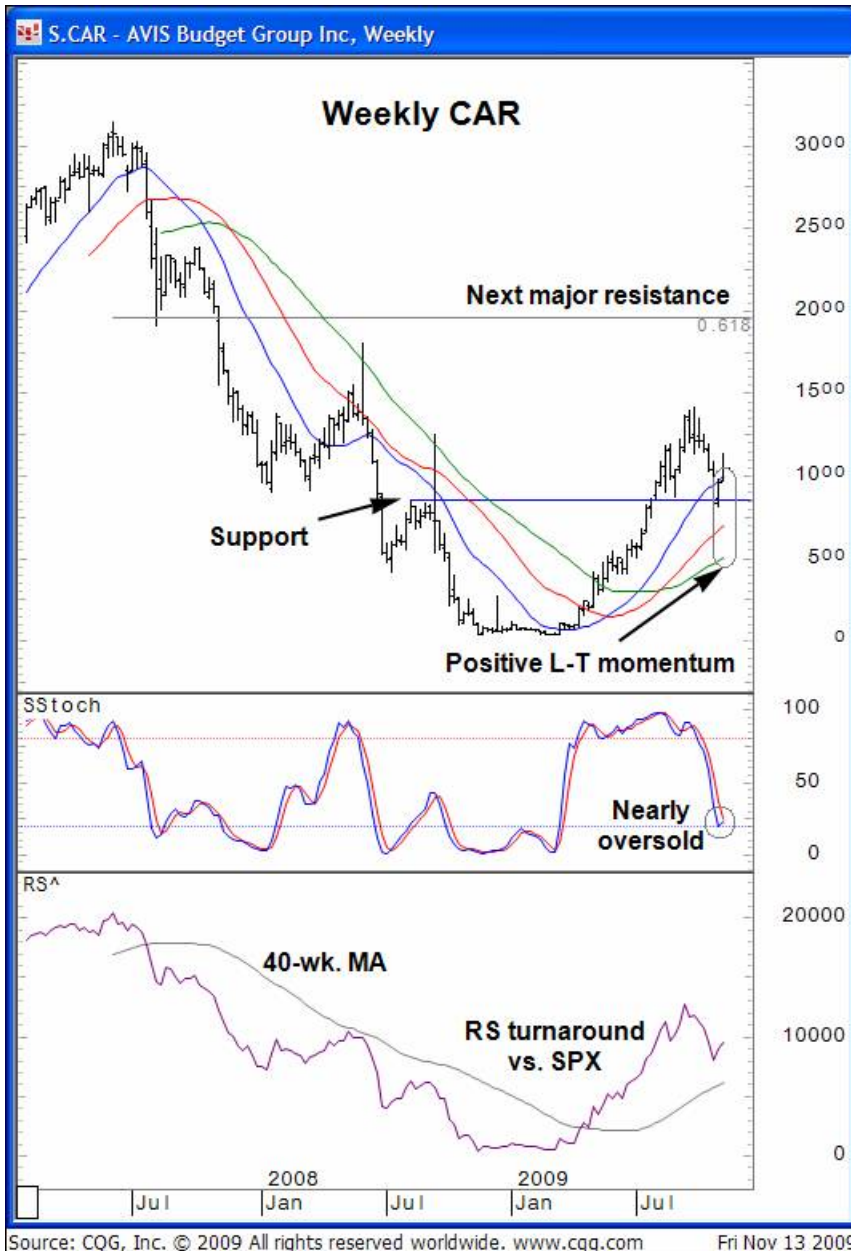
**this year, to a gain of \$0.72 in 2010E and \$1.40 in 2011E, based on our estimates. We believe the company is at the start of a three-stage earnings recovery: (1) the current strong leisure pricing environment continues into 2010; (2) corporate travel volumes stabilize and then recover due to GDP growth and easier year-over-year comps; and (3) we see increased operating leverage as a result of actions management has taken: right-sizing the fleet, cutting \$380-\$440 million of costs (run-rate), strengthening the balance sheet, and eliminating unprofitable locations and transactions. Our 12-month**



price target of \$18 is based on 13x our 2011 EPS. We believe 13x is an appropriate given the strong earnings growth and it is also the adjusted historic average multiple. The EV/EBITDA on our 2011 estimate is 5.9x.

**Implied volatility (IV) in CAR is persistently rich, with 3-month IV having averaged 78% over the past three years. Currently at 91%, IV actually peaked in March of this year at 344% when the stock price was just \$0.36/share, weighted down by the threat of an impending General Motors bankruptcy filing.**

**Given our expectation that evidence of sustained pricing power over the next few months will catalyze share gains into 2010 towards our \$18/share target price, we like initiating long stock positions (stock reference \$10.47/share). Additionally, we want to take advantage of the rich level of implied volatility by selling a May 2010 7.5/12.5 strangle at \$2.75, or 26.3% of the underlying price. Premium taken in from selling strangles hedges the stock position down to \$7.72/share and does not commit to getting long additional shares until the equivalent of \$4.75/share or 54.6% lower. At that level we would be aggressive buyers based on fundamental valuation. In the case that CAR rallies above the 15 call strike, the long stock would be called away at the equivalent of \$15.25/share, or 45.7% higher. In the event that stock remains between \$7.5 and \$12.5/share at expiration, the \$2.75 is kept for an equivalent 26.3% dividend.**



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**According to Katie Stockton our technical analyst, CAR pulled back sharply in October, relieving intermediate-term overbought conditions.** The posture of the chart is bullish, given the reversal of a long-term downtrend earlier this year. Long-term momentum is positive based on the TMAP model, which consists of the 20-, 35-, and 50-week moving averages. We expect support near \$8.50 to serve as the staging ground for the next significant upleg, well above the \$4.75 floor. The next major resistance on the chart is near \$20 based on a Fibonacci retracement level, which is above our fundamental target. Additionally, CAR has a healthy relative strength outlook compared to the S&P 500 Index (SPX).

**MKM Trade Idea**

**With stock reference \$10.47/share, initiate a long stock position in CAR and simultaneously sell a May 2010 7.5/12.5 strangle at \$2.75. The position commits to get longer stock for \$4.75/share or 54.6% lower, and long stock is sold at the equivalent of \$15.25/share, or 45.7% higher.**

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4. Spreads face unique risks during expiration: Expiring spreads may require action if the long leg is out-of-the money less than .01 or out-of-the-money, while the short leg is in-the-money. Although we use our best positions and for the risks associated with any unhedged spread leg expiring in-the-money. In the event that you do not wish to exercise an expiring long leg, you must notify us by 4:00 pm ET in order to prevent the possibility that we will exercise this long position on your behalf.
5. The assignment process: According to the policy and practice of our clearing agents, assignments are distributed on a random basis amongst all holders of eligible options amount the accounts carried on their books. Please contact us if you need more information about this process. For any questions relating to the exercise process or regarding expiring options, please contact our Trading Desk at 203-861-9060.

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