Warrant (finance)

From Wikipedia, the free encyclopedia

For other uses of the term Warrant, see Warrant (disambiguation)

A warrant is a security that entitles the holder to buy stock of the company that issued it at a specified price, which is much higher than the stock price at time of issue. Warrants are frequently attached to bonds or preferred stock as a sweetener, allowing the issuer to pay lower interest rates or dividends. Frequently, these warrants are detachable, and can be sold independently of the bond or stock. Warrants are much like call options, but the money goes to the issuer, not an option writer, and it initially has a lifespan of many years. When the warrant is exercised the company issues new shares of stock, so the number of outstanding shares increases. When a call option is exercised, the owner of the call option receives an existing share from an assigned call writer (except in the case of employee stock options, where new shares are created and issued by the company upon exercise). Unlike common stock shares outstanding, warrants do not have voting rights.

Sometimes the issuer will try to establish a market for the warrant and to register it with a listed exchange. In this case, the price can be obtained from a broker. But often, warrants are privately held or not registered, which makes their prices less obvious. Once the warrants are in the secondary market, they can then be traded just like a stock. Warrants can be easily tracked by adding a "w" after the company’s ticker symbol to check the warrant's price.

Contents

- 1 Duration
- 2 Other differences
- 3 Types of Warrants
  - 3.1 Traditional
    - 3.1.1 Example
  - 3.2 Naked
  - 3.3 Third Party Warrants
  - 3.4 Government issued
- 4 Traded warrants
- 5 Source
- 6 External links
- 7 See also

Duration

Another difference between a warrant and an option is the duration of the contract. A warrant's lifetime is measured in years (as long as 15 years), while options are typically measured in months. Even LEAPS (long-term equity anticipation securities), the longest stock options available, tend to expire in two or three years. Upon expiration, the warrants are worthless if not exercised unless the price of the common stock is greater than the exercised price.

Other differences

In many respects, options and warrants are functionally similar, except that warrants are not standardised like ASX-listed options. While investors can write stock options on the ASX, they are not permitted to do either with ASX-listed warrants, since only companies can issue warrants, and while each option contract is over 100 underlying ordinary shares, the number of warrants that must be exercised by the holder to buy the underlying asset depends on the conversion ratio set out in the offer documentation.
Types of Warrants

Traditional

Traditional warrants are issued in conjunction with a Bond (known as a warrant-linked bond), and represent the right to acquire shares in the entity issuing the bond. In other words, the writer of a traditional warrant is also the issuer of the underlying instrument. Warrants are issued in this way as a 'sweetener' to make the bond issue more attractive, and to reduce the interest rate that must be offered in order to sell the bond issue.

Example

- Price paid for bond with warrants $P_0$
- Coupon payments $C$
- Maturity $T$
- Required rate of return $r$

Value of warrants = $P_0 - \left( \sum_{t=1}^{T} \frac{C}{(1+r)^t} + \frac{F}{(1+r)^T} \right)$.

Naked

Naked warrants are issued without an accompanying bond, and like traditional warrants, are traded on the stock exchange. They are typically issued by banks and securities firms. These are also called covered warrants, and are settled for cash, e.g. do not involve the company who issues the shares that underly the warrant. In most markets around the world, covered warrants are more popular than the traditional warrants described above. Financially they are also similar to call options, but are typically bought by retail investors, rather than investment funds or banks, who prefer the more keenly priced options which tend to trade on a different market. Covered warrants normally trade alongside equities, which makes them easier for retail investors to buy and sell them.

Third Party Warrants

Third-party warrant is a derivative issued by the holders of the underlying instrument. Suppose Company X issues one million warrants which gives the holder the right to convert each warrant into one share at $500. This warrant is company-issued. Suppose, a mutual fund that holds 10,000 shares of X sells warrants against those shares, also exercisable at $500 per share. These are called third-party warrants. The primary advantage is that the instrument helps in the price discovery process. In the above case, the mutual fund selling a one-year warrant exercisable at $500 sends a signal to other investors that the stock may trade at Rs 500 levels in one year. If volumes in such warrants are high, the price discovery process will be that much better; for it would mean that many investors believe that the stock will trade at that level in one year. Third-party warrants are essentially long-term call options. The seller of the warrants does a covered call-write. That is, the seller will hold the stock and sell warrants against them. If the stock does not cross $500, the buyer will not exercise the warrant. The seller will, therefore, keep the warrant premium.

Government issued

Also, when a government agency issues checks which they are unable to pay (due to lack of money) but are redeemable some point in the future, usually with interest, these are also called warrants. In the late 1990s, when the State of California had a budget crisis due to a disagreement between the governor and the legislature, the state treasurer was forced to issue warrants paying 18% interest in lieu of being able to pay the state's bills with real money. The state had not issued warrants since before the Depression of the 1930s. Many institutions accepted them at face value because of the interest provision. Interestingly, the controller of Los Angeles County was buying the warrants because the county had surplus funds to take advantage of the higher interest rates on the warrants.

In some states, a warrant is a demand draft drawn on a government's treasury to pay its bills. Checks or electronic payments have replaced these warrants, but in Arkansas, some counties and school districts uses warrants for non-electronic payments.
Traded warrants

"Traditional" warrant
Naked warrant
Exotic warrant
    Barrier warrant
    Hit-warrant
    Turbo warrant
    Snail warrant
    third party warrants

Source

- Incademy
- Investopedia
- Invest-FAQ
- SmartMoney.com

External links

- Restricted Securities Education Center
- Article: Discounts for Illiquid Shares and Warrants
- Chicago Board Options Exchange
- Finance glossary by SGCIB

See also

- List of finance topics
- Option (finance)
- Stock option
- Derivative (finance)
- Derivatives market

Financial derivatives v d e

Options

Types: Vanilla: Option styles | Call | Put | Warrants | Fixed income | Employee stock option | FX
Exotics: Asian | Lookback | Barrier | Binary | Swaption | Mountain range
Strategies: Covered call | Naked put | Straddle | Strangle | Butterfly
Spreads: Bull spread | Bear spread | Calendar spread | Vertical spread | Debit spread | Credit spread

Valuation: Moneyness | Option time value | Black-Scholes | Black | Binomial
Volatility: Stochastic volatility | Implied volatility | Net volatility | Local volatility | Volatility arbitrage
See Also: CBOE | Derivatives market | Option screener | Option strategies | Pin risk

Swaps

Interest rate | Total return | Equity | Credit default | Forex | Cross-currency | Constant maturity | Basis | Variance


Categories: Corporate finance | Options | Equity securities

- This page was last modified 18:31, 6 September 2007.
- All text is available under the terms of the GNU Free Documentation License. (See Copyrights for details.) Wikipedia® is a registered trademark of the Wikimedia Foundation, Inc., a U.S. registered 501(c)(3) tax-deductible nonprofit charity.