Rights and Warrants: Are they right for you?

Most investors these days begin their investing with mutual funds. As they become more experienced, and have more capital to invest, they may venture into the world of trading individual securities. At this point, investors are exposed, sometimes for the first time, to rights and warrants. These instruments give you the right to purchase shares in a company.

You want me to spend money to buy a security that allows me to buy a security? I don't think so! Well, think again, this may be just what you want to do.

What are rights and warrants?

Sometimes, when a company wants to raise more money, it will issue rights. These allow the shareholder to buy more shares directly from the company, usually at a price somewhat lower than the current market price of the outstanding shares. This is a way for a firm to raise more funds in a way that favours existing shareholders.

A warrant is often attached to new debt or preferred issues to make these issues more attractive to buyers, thereby functioning as a "sweetener". The company uses the warrants to raise more money down the road.

The major difference between rights and warrants is their lifespan. Rights usually expire after a few weeks, while warrants can continue from one to several years. Both can trade on the market separately from the company's stock.

The customary method of making a rights offering is to issue one right for each common share outstanding. You can then combine the rights into the multiples required for one or more shares and subscribe. No commission is levied when you exercise the rights and acquire new shares. Normally, fractional shares are not issued. Warrants are similar except that quite often it only takes one warrant to purchase on share, not several warrants, as is the case with rights.

A ready market usually develops, permitting rights and warrants to be sold or more to be bought. The possibility that the market price of the stock will fall below the subscription price is of major importance in setting the terms of an issue. If this happened, investors wouldn't exercise their rights or warrants and the issue would fail.

Intrinsic value and time value of rights and warrants

The value of a right or a warrant closely resembles the difference between its subscription price and the market price of the underlying stock. Intrinsic value is the amount by which the market price of the underlying common stock exceeds the subscription price (also known as the exercise price).

A right or warrant has no intrinsic value if the exercise price is above the current market value of the shares; however, it will still usually have a market value known as time value because of perceived speculative potential up to the expiry date. Once rights and warrants expire, they are worthless and may not be exercised.

Intrinsic Value = Stock Price – Subscription Price
Time Value = Right Price – Intrinsic Value
Right Price = Intrinsic Value + Time Value

Leverage – the main attraction of warrants

The main speculative attraction of warrants is their leverage potential. The price of a warrant is usually much less than the price of the underlying security and generally moves together with it. The capital appreciation of a warrant on a percentage basis can, therefore, greatly exceed that of the underlying security.

The chart below illustrates the idea of leverage. Assume there is a warrant with a market value of $4, exercisable at $12 on an underlying common share whose market price is $15. If the common share price rises to $23 before the warrants expire, the warrants would rise to at least their intrinsic value of $11 ($23 - $12), an increase of 175% of the original outlay. The common shares would have appreciated only 53%.

Of course, the reverse is also true. A fall in the price of the common share from $15 to $11 results in a 27% loss in share value compared with a potential loss of 100% in the value of the warrant, assuming again that it has no time value.

Warrant exercisable at $12, trading at $4, when the underlying common stock is trading at $15. What happens as expiry approaches?

	Share price falls to $11	Share price falls to $12	Share price remains at $15	Share price rises to $23
Warrant Price	$0	$0	$3	$11
Intrinsic Value	$0	$0	$3	$11
Time Value	$0	$0	$0	$0
Stock $ Gain (Loss)	($4)	($3)	$0	$8
Stock % Gain (Loss)	(27%)	(20%)	0%	53%
Warrant $ Gain (Loss)	($4)	($4)	($1)	$7
Warrant % Gain (Loss)	(100%)	(100%)	(25%)	175%

The price of rights and warrants tends to rise and fall in the secondary market as the price of the common stock fluctuates, although not necessarily to the same degree. A holder of rights or warrants may take any one of the following four courses of action:

- exercise some or all of the rights or warrants;
- sell some of all of the rights or warrants;
- buy additional rights to trade or exercise later;
- do nothing and let the rights expire.

Doing nothing, of course, provides no benefit. Rights and warrants are not automatically exercised on behalf of their holders. But, to choose the appropriate course of action may prove to be difficult for novice investors.

Call your investment advisor and ask for his or her advice. Your advisor will help you decide whether these instruments are right for you. There are many factors that require evaluation and your IA very likely has a much better perspective on which option to choose when you do own them.