

CANADIAN COMPOUNDS

Compound options are this season's fashion in Canada among retail investors looking for leveraged plays on domestic and US stock markets. Similar structures are also popular with liability managers looking for tailored hedges to fit their corporate constraints of lower credit ratings and tighter cash flows.

Among the structures aimed at the retail market are two-year Toronto 35 Index (TSE-35) put instalment warrants and two-year S&P 500 call and put instalment warrants. Both were issued by BT Canada Securities, the Canadian securities arm of Bankers Trust, with Midland Walwyn Capital as lead underwriter.

On April 13, a total of 2.8 million TSE-35 put warrants were sold and listed at the Toronto Stock Exchange, representing C\$14 million in premium paid out and C\$120 million in notional equity exposure. The S&P instalment warrants were even more popular - 2.05 million calls and 4.6 million puts were sold, representing C\$33.3 million in premium and C\$270 million in notional equity exposure. These warrants were designed to eliminate currency exposure from the investment, offering Canadian investors a straight play on the S&P 500 index.

The new wrinkle for the Canadian investors, who have bought billions of Canadian dollars worth of instalment receipts in the past 18 months and generally made out quite well, was the way the warrant premium was to be paid. After paying an initial premium of C\$2.50, they were given the right to decide, within 12 months, if they wanted to pay another C\$2.50 to continue owning the right to exercise these warrants. (Second instalments of this kind are mandatory on traditional instalment receipts for common shares.) This added flexibility with these warrant issues represented a one-year renewal option on each two-year deal.

"The second instalment is optional," explains Brian Blair, senior vice-president and director of corporate finance at Midland Walwyn in Toronto. "Investors can choose to extinguish their option simply by not paying the second instalment. We view this compound option feature as something very appealing to the investor with a strong directional bias."

According to Nico Meijer, vice-president in Citibank Canada's exposure management group in Toronto, liability hedgers in Canada have taken a liking to similar products in the interest rate market, called rental caps and swaptions.

In general economic terms these options are no different from the BT structures, but instead of having one instalment option, corporate hedgers choose how many instalment periods they would like and the premiums they will pay over each time interval.

Citibank's Meijer refused to disclose the names of Canadian corporates executing these structures but said several have dabbled in this market. He cited a five-year, C\$100 million instalment option on five-year debt, whose premium was paid out evenly over 18 months, as representative of what's happening in this market. Such structures, he noted, can be done against any floating-rate index.

"The premium a hedger pays really depends on how the rental structure is set up," Meijer says. If the instalment premiums are paid out over the first year, he estimates that such a structure might have an all-in cost that is 25-40% more than for a conventional single-premium option, depending on market conditions.

If the structure is extended over a longer time frame, the option may have a premium double that of a straight cap or swaption of similar maturity. While more premium is potentially paid out, a corporate can extinguish the structure if it looks as if it will expire worthless.

"These structures appeal to companies that are not cash rich and may have tighter credit restrictions," he adds. "The structure may be more expensive, but it also gives

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them flexibility to drop the hedge and manage cash flows better."

Canadian retail investors, in contrast, were attracted to instalment warrants that offered them attractive leverage initially, even if their all-in cost was potentially more than that of a straight two-year option on the TSE-35 or S&P 500. For example, if a C\$5 warrant was worth C\$6 at expiry, it would represent a return of 20%. In contrast, a C\$2.50 warrant that went into the money by the same amount, C\$1, would generate a return of 40%.

Some cynical market participants say these instalment warrant issues are complex options that retail investors can't possibly value accurately. But Albert Yu, vice-president in the capital markets group at BT Bank of Canada in Toronto, disagrees: "These instalment options offer more flexibility to the investor. Whenever an investor has more choice, that means the total value of the instalment option is worth more."

Izzy Nelken, president of Super Computer Consulting, sees things slightly differently. He points out that a typical compound option would involve a European call being exercised on a European put. In the case of the TSE-35 warrants, however, BT has structured the underlying put to be American-style rather than European. Nelken

calculates a theoretical "fair value" of each TSE-35 put instalment warrant, using compound option pricing methodology and assuming a volatility of 20% and a risk-free interest rate in Canada of 5.49%, to be approximately C\$2.14.

He thus estimates that C\$0.36 has been tacked on to the price of each warrant sold. The issue's prospectus, however, discloses commission of C\$0.30 per warrant.

Canadian retail investors are apparently unconcerned with theoretical values. Louis Vachon, vice-president in the capital markets group at BT Bank of Canada in Toronto, declined to comment on the mark-up in the structure, which is hedged in the wholesale derivative markets by Bankers Trust. But he did point out that investors who waited for the TSE-35 warrant to trade at a discount in the secondary market in the hope of buying them at below the new issue price were rudely disappointed.

Indeed, soon after the TSE-35 put instalment warrant was issued at C\$2.50, it traded up as high as C\$3.60 (see chart below). It has since dropped into a range of \$3.00, but certainly has offered investors who jumped in early some healthy profit potential. With a strike price at 215.057, the TSE-35 index level must fall at least 11.7% before the warrant is in the money, assuming it is held to final maturity.

In contrast, the S&P put and call warrants were issued at a strike price of 461.6367, the average of the S&P index's value three days prior to closing on June 17. The calls were issued on a premium of 16.6% and the puts on 11.1%. On June 17, the first day of trading, the closing trading price for the S&P 500 call warrants was C\$2.40; for the put instalment warrants, C\$2.70.

Demand for the S&P instalment warrants far outstripped that for the TSE-35 new issue. Most likely, many Canadian investors haven't forgotten their success with Nikkei put warrants in the late 1980s, also issued by Bankers Trust. At that time, approximately C\$94 million was converted into C\$400 million in intrinsic value for Canadian investors, according to Midland's Blair. He predicts more instalment warrants of a similar type being launched soon, perhaps even on commodity or currency benchmarks.

"The Ontario Securities Commission has streamlined the disclosure process somewhat for the dealers," he says. "The cost of doing warrants like this has been reduced to as little as a third of what it used to be, and approval time has been cut from between three and six months to as little as six weeks. So I'm far more encouraged about this market's potential than I was a year or so ago." ■

William Falloon

BT TSE-35 put instalment warrant prices, Apr 14-Jun 14, 1994

