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CORPORATE EQUITY WARRANTS

Arbitrage-Free Pricing and Implications for Corporate Finance

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Abstract

Corporate Equity Warrants
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Usually attached as “sweeteners” to other securities, especially as a part of a common stock initial public offering, corporate equity warrants are a fascinating capital-raising tool available to corporate finance officers. At a first approximation, equity warrants are option-like securities. In fact, like ordinary call options, they are transferable certificates which entitle the holder to buy a specific number of shares in the issuing company, at a given price, at an agreed time in the future. According to this similarity, the pricing of warrants is usually performed by application of the standard option pricing theory. Nonetheless, the theoretical and empirical analysis of warrants still remains an open field within the financial literature. The reason is principally that valuing warrants is more complicated than valuing options. The presence of some warrant specific features prevents from using simple plain-vanilla formulas and adds a certain degree of complexity to the analysis.

The purpose of this thesis is to analyse corporate equity warrants, trying to address some of the main open questions about their value. The first chapter describes the fundamentals on equity warrant investment and the economic rationale of issuing these instruments is examined from a corporate finance point of view. The second chapter is devoted to reviewing the financial literature about warrant pricing and presenting some commonly accepted formulas. Afterwards, the relationship between warrants and the volatility of the underlying stock return is examined in chapter three. Contrarily to the classical stock options, in fact, warrants affect the capital structure of the issuing firm and produce an interesting risk-shifting effect among equity claimants. Chapter four derives an alternative approach to pricing equity warrant, embedding this risk-shifting feature, and proposes a theoretical simulation proving its accuracy. Finally, chapter five empirically tests the proposed warrant pricing model employing a sample of Italian listed warrants and concludes the study.
Contents

List of Symbols vii

1 General Background 1
  1.1 Fundamentals on Equity Warrants 1
  1.2 Warrant Price and Its Components 7
  1.3 Adjustment of Subscription Rights 10
  1.4 Economic Rationale for Issuing Warrants 16
  1.5 The Italian Background 23

2 The Valuation of Warrants 31
  2.1 Theoretical Pricing Models 31
  2.2 Empirical Tests of the Pricing Models 43

3 Warrants and Stock Volatility 51
  3.1 The Risk-Shifting Effect 51
  3.2 Risk-Shifting Vs. Leverage Effect 64

4 An Alternative Pricing Approach 73
  4.1 Approximating the Stock Volatility 73
  4.2 Simulation Tests and Sensitive Analysis 79
  4.3 Empirical Test 83

5 The Empirical Pricing Test 91
  5.1 Analysis of a Leveraged Firm 91
  5.2 Data Description and Methodology 92
  5.3 Conclusion 105

A Results from Stochastic Calculus 111
  A.1 Itô's lemma 111
  A.2 CEV Diffusions 112
A.3 Correlation Between Stock and Warrant ......................... 114

B Derivation of the CEV $\gamma$ Parameter ....................... 115
  B.1 Unleveraged Firm ........................................... 115
  B.2 Leveraged Firm ............................................ 116

Bibliography .................................................. 117