

# A PRIMER ON DERIVATIVE WARRANTS AS TRADING STARTS ON THE SET

## GURU SPEAK

**RINJAI CHAIYASUT**

## The Stock Exchange of Thailand

Derivative warrants (DWs) began listing and trading on the Stock Exchange of Thailand (SET) just this past month. But what are they, and why should investors be interested in them?

What is a DW? It is an instrument that gives the holder the right – but not the obligation – to either buy or sell, as the case may be, the specified underlying securities at an agreed-upon price and date.

Currently, DWs traded on the SET must be “call warrants”, which is an instrument providing investors the right to buy the specified underlying stock at the stated price. The underlying stock of a DW must be a constituent of the SET50 Index. These 50 stocks have large capitalisations and are highly liquid.

Whereas warrants currently traded on the SET are issued by listed companies, DWs are issued by a third party, which must be a securities company or financial institution approved by the Securities Exchange Commission.

Thus, in addition to risk from possible changes in the price of the DWs held, investors must consider the credit risk of the issuer – that is, the ability of the issuer to perform the obligations stated in the terms and conditions of the DWs in question. In contrast, such a credit risk does not apply to company warrants, as listed companies can always deliver their shares by issuing new shares when investors exercise their rights.

If an investor exercises the listed DW, he/she does not get the shares, but the issuer pays the

difference between the exercise price and the market price of the underlying stock.

For example, the terms and conditions of PTT13CA – the first DW listed on the SET – state that holders of five DWs have the right

to buy one share of PTT at Bt251.90. If the closing price of PTT is Bt300 on the exercise date, an investor holding 100 units of PTT13CA would have the right to buy 20 shares of PTT, and the issuer would pay him  $(Bt300 - Bt251.9) \times 20$  shares = Bt962.

In practice, a DW holder does not need to wait until the exercise date to get the cash settlement. Instead, he can always sell his DWs on the SET to realise capital gains from price appreciation.

DW prices are determined by several factors, such as the underlying stock price. If the price of the underlying stock increases, the price of its DWs will rise also.

Another factor is stock volatility. If volatility of the underlying stock increases, the price of its DWs will follow suit, as the probability that DWs will end up in the money – with the stock price higher than the exercise price – will increase.

DWs offer investors the opportunity to obtain high returns, due to their nature. Using DWs, an investor can gain the same exposure to the underlying stock at much lower cost than if he buys the underlying stock. For example,

if an investor buys 100 shares of PTT at Bt235 per share, this will cost him Bt23,500. An alternative – given a ratio of five DWs to one underlying share – is for him to

buy 500 units of DW at Bt5.75 per unit, costing him only Bt2,875 to gain the same exposure. From an investment of Bt5.75 per unit, if PTT13CA increases by Bt1, the rate of return will be around 17 per cent. As for PTT, if the PTT price increases by Bt1, a rate of return would be only 0.43 per cent. Thus, the gearing of DWs provides investors with an opportunity to get a higher rate of return than with a stock investment.

Nevertheless, investors must be aware that PTT13CA is the right to buy PTT at Bt251.90. Thus, if the PTT price goes against their expectations, for example by falling below Bt251.90, the investor will lose the entire amount he paid for PTT13CA.

The first SET-listed DW, PTT13CA, has been traded for about a month now. It is expected that this month KGI Securities will issue another DW, on Kasikornbank. KGI is filing the necessary application with the SEC.

Although the DW market in Thailand is in the initial stage of development, the SET expects that other brokerage firms will join KGI in issuing DWs. Gauging from the success of DWs in other stock markets, it seems that this instrument will be popular here as well.

**RINJAI CHAIYASUT** is head of product development at the Stock Exchange of Thailand.