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Why Warrants Are the Worst of Wagers

A Monday Morning Musing from Mickey the Mercenary Geologist

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A warrant is a common financial instrument designed to entice speculators' participation in a company's private placement. It grants the participant a fixed price option to acquire another share in the company at a future date. Private placement units commonly consist of a share and a half or full warrant with a one- to a five-year expiration date.

I opine that a warrant is a financial instrument that in the vast majority of cases has zero value. There are some obvious reasons why this is true and I detail them in the missive below.

But first, I present my own anecdotal evidence:

From 2013 to the present, I participated in 35 junior resource company private placements; 23 included an attached warrant. Five were private startups and five were shells, reverse takeovers, or spin-outs that came without a warrant. Two of the placements that had no warrant were secondary financings for an RTO and a spinco, and both were priced at significant discount to the market.

Folks, here's the sad truth about these 23 warrant speculations:

- Thirteen have expired out-of-the-money.

- Four were out-of-the-money but at my request (or insistence) prior to expiry, have been extended for another year.

- Another two are currently out-of-the-money but have not yet expired.

- Four were in-the-money and were exercised.

So with hope and perhaps a prayer (if you are religious), the jury is still out on six warrants.

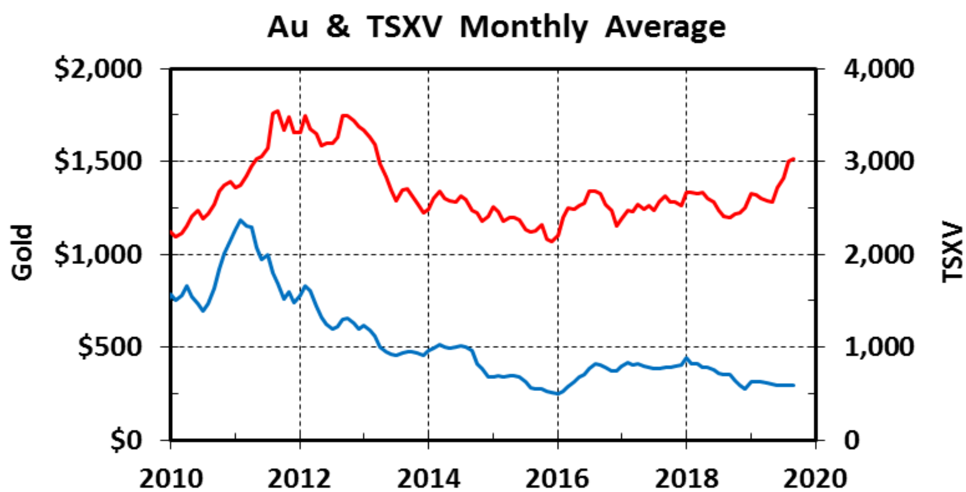
That said, of the 17 warrants that are said and done, only four were exercised and sold at a profit; that's less than 25% winners!

Rest assured that I am not alone in my recent history of junior resource speculations. In several discussions with other professional speculators, we reached a general consensus that only one in every four or five warrants are in-the-money and exercised prior to expiry.

So let's explore some reasons for this abysmal record. Certainly, macroeconomic factors have been important:

- Gold peaked in Q3 of 2011, maintained a robust price thru late 2012, went into a severe decline from early 2013 until early 2016, and then was relatively flat from mid-2016 until mid-May of this year. Its bull market run is currently of less than five months duration.

- Junior resource stocks peaked in Q1 of 2011, declined in a bear market thru Q1 of 2016, and broadly mimicked the gold price until mid-Q2 2019. Despite a 17% gain in gold since mid-May, the bad market for juniors is unabated with the TSXV Index hitting a year-to-date low at Friday's close.



That said, the price of gold and the performance of the junior stock market are merely a part of this story.

I submit there is a fundamental flaw in the standard equity financing model and structure that demands private placement units include a share and a warrant. My reasoning is outlined below:

- Many institutional investors, funds, and brokers take positions in a private placement with plans to sell into the market once the four-month hold is over and there is sufficiently liquidity to off their entire positions.

- Their purpose is to shed all risk by breaking even on the shares and retain the warrants as a call on the company's future upside.

- These stock dumps often cause a company's share price to spike once free-trading begins then crater when the generated liquidity dries up.

- Warrants that remain out-of-the-money serve as an overhang on the stock and become strong resistance to a higher share price, particularly when expiration dates are near-term.

- This resistance often begets another equity placement priced below the existing warrant strike price.

- In a bear market, warrant overhangs can lead to a series of dilutive private placements at lower and lower prices and to the detriment of the company's committed, early-stage shareholders.

- Some warrants are free-trading upon exercise and some have a four-month hold restriction. According to a trusted broker, this determination is made by the lawyers that the company chooses to retain.

- Moreover, if you are an American resident, the new stock certificate comes burdened with a US-restricted legend that requires clearance before the stock can be sold. It is a legal, regulatory, and bureaucratic process that involves the company, a broker, a lawyer, and a transfer agent; fees of up to $500 are billed to the shareholder.

- The legend removal process results in an additional hold period of four to six weeks (or more) before the stock can be sold and its exercise cost recouped.

Folks, the gist is this: Private placement warrants seldom reward speculators with the opportunity they envision. Moreover, unexercised warrants often present a significant hindrance to a junior company's share price, share structure, and future financial fortunes. .

At this juncture, I am only interested in early-stage financial opportunities in properly-constructed private startups, clean shell companies with well-constructed structures, and/or reverse takeovers of the above.

I assume significant risk with a five-plus month trading hold on every private placement. For the reasons outlined above, I do not want a warrant attached on the term sheet. If you really want to attract my hard-earned American dollars, I strongly suggest financing at significant discount to the market price.

To wit: Warrants are often the worst of wanton and wasted wagers and seldom have future value.

I will still consider a financing that features warrants but it must be a compelling story with a group of strategic investors who are demonstrably committed to the company and an orderly market that responds positively to exploration success.

Otherwise, for any story I like, I can purchase free-trading shares on the open market.

Ciao for now,

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The **Mercenary Geologist Michael S. "Mickey" Fulp** is a Certified Professional Geologist with a B.Sc. in Earth Sciences with honor from the University of Tulsa, and M.Sc. in Geology from the University of New Mexico. Mickey has 40 years of experience as an exploration geologist and analyst searching for economic deposits of base and precious metals, industrial minerals, uranium, coal, oil and gas, and water in North and South America, Europe, and Asia.

Mickey worked for junior explorers, major mining companies, private companies, and investors as a consulting economic geologist for over 20 years, specializing in geological mapping, property evaluation, and business development. In addition to Mickey's professional credentials and experience, he is high-altitude proficient, and is bilingual in English and Spanish. From 2003 to 2006, he made four outcrop ore discoveries in Peru, Nevada, Chile, and British Columbia.

Mickey is well-known and highly respected throughout the mining and exploration community due to his ongoing work as an analyst, writer, and speaker.

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