

# Warrants Alert

INDEPENDENT ADVICE ON UK WARRANTS - PUBLISHED SINCE 1989

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Another month of heavy price falls in equity markets around the world has hammered warrant prices. Investment trust and company warrants have dropped by an average of 26.5% over what has obviously been another torrid autumnal month. We will not try to pinpoint when any recovery might start - it may even have already done so - but our plan in this issue is to sort out a few opportunities and to highlight the warrants which we think might lead the way under different scenarios. The rapid shifts in the valuations of financial assets has meant some extraordinary profits in covered warrants on the short side of equities, oil, and sterling, but for most investors it has of course meant the pain of some nasty losses. Some of these will be best dealt with: the rotting carcasses of some warrants will need to be excised from portfolios. In other cases we think warrants may be able to recover in time, and to offer good upward potential for new purchases at these much reduced levels. **Amongst the items in this month's newsletter, we run through the corporate warrants universe and select our five top picks for recovery.** We also look ahead with eager anticipation to the entry of Royal Bank of Scotland into the UK covered warrants market, scheduled for next week.

## Corporate Warrants

### Major Price Rises Over the Month

Matra Petroleum	42.9%
Epicure Qatar Equity	37.5%
Jupiter Green	3.8%

### Falls

Clean Energy Brazil	-91.2%
Chaucer Holdings	-78.0%
BlackRock World Mining	-77.8%
NextGen	-73.5%
Origo Sino-India	-73.5%
Aricom	-73.0%
Oakley Capital Invs	-69.2%
Utilico Emerging Markets	-69.0%
Golden Prospect Precious	-63.5%
Advance Frontier Markets	-61.9%
Prospect Epicure J-REIT	-56.0%

## Covered Warrants

### Major Price Rises Over the Month

SK78 Brent Crude Oil 60 P 10-Nov-08	+5572.41%
SK79 Brent Crude Oil 70 P 10-Nov-08	+3307.89%
SM49 Brent Crude Oil 80 P 10-Nov-08	+1568.50%
SM96 BP 725 C 19-Dec-08	+1536.00%
SM10 Shell 2300 C 19-Dec-08	+1268.97%
SU41 RBOS 100 P 19-Dec-08	+1064.27%
SM50 Brent Crude Oil 90 P 10-Nov-08	+804.89%

### Falls

SK76 Brent Crude Oil 100 C 10-Nov-08	-99.24%
SM47 Brent Crude Oil 90 C 10-Nov-08	-99.06%
SM48 Brent Crude Oil 110 C 10-Nov-08	-98.73%
ST91 Cocoa 3000 C 07-Nov-08	-98.29%
SK77 Brent Crude Oil 80 C 10-Nov-08	-97.39%
SW76 RBOS 230 C 20-Mar-09	-96.02%
ST35 Brent Crude Oil 130 C 10-Nov-08	-96.00%

Warning: you should not buy shares or warrants with money you cannot afford to lose. This newsletter is intended for UK investors. Options and other derivatives, warrants, and margined transactions. This warning notice draws your attention to some of the high risks associated with warrants. The risks attaching to instruments and transactions of this kind are usually different from, and can be much greater than, those attached to securities such as shares, loan stock and bonds, such transactions often having the characteristics of speculation as opposed to investment. Warrants may involve a high degree of 'gearing' or 'leverage'. This means that a small movement in the price of the underlying asset may have a disproportionately dramatic effect on your investment. A relatively small adverse movement in the price of the underlying asset can result in the loss of the whole of your original investment. Moreover, because of the limited life of warrants, they may expire worthless. A warrant is a right to subscribe for shares, debentures, loan stock or government securities, usually exercisable against the original issuer of the securities. Because of the high degree of gearing which they may involve, the prices of warrants can be volatile. Accordingly, you should not buy warrants with money you cannot afford to lose. You run an extra risk of losing money when you buy shares in certain smaller companies including 'penny shares'. There is a big difference between the buying price and the selling price of these shares. If you have to sell them immediately, you may get back much less than you paid for them. The price may change quickly, it may go down as well as up, and you may not get back the full amount invested. It may be difficult to sell or realise the investment. Because of the volatile nature of the investment, a fall in its value could result in your recovering nothing at all. Changes in rates of exchange may have an adverse effect on the value or price of the investment in sterling terms. As with other investments, transactions in warrants, shares, and investment trusts may also have tax consequences and on these you should consult your tax adviser. Securitised Derivatives: these instruments may give you a time-limited right to acquire or sell one or more types of instrument which is normally exercisable against someone other than the issuer of that investment. Or they may give you rights under a contract for differences which allow for speculation on fluctuations in the value of the property of any description or an index, such as the FTSE 100 Index. In both cases, the investment or property may be referred to as the "underlying instrument." These instruments often involve a high degree of gearing or leverage, so that a relatively small movement in the price of the underlying investment results in a much larger movement, favourable or unfavourable, in the price of the instrument. The price of these instruments can therefore be volatile. These instruments have a limited life, and may (unless there is some form of guaranteed return to the amount you are investing in the product) expire worthless if the underlying instrument does not perform as expected. You should only buy this product if you are prepared to sustain a total loss of the money you have invested plus any commission or other transaction charges. You should consider carefully whether or not this product is suitable for you in light of your circumstances and financial position, and if in any doubt please seek professional advice. We have taken all reasonable care to ensure that all statements of fact and opinion contained in this newsletter are fair and accurate in all material respects. Investors should seek appropriate professional advice if any points are unclear. This material is intended to give general information only, and the investments mentioned are not necessarily suitable for any individual. It is possible that the McHattie Warrants Alert Fund or officers of the McHattie Group may have a beneficial holding in any of the securities mentioned. Andrew McHattie, the editor of this newsletter, is responsible for preparing the research recommendations contained within. Published by The McHattie Group, St Brandon's House, 29 Great George Street, Bristol, BS1 5QT. © 2008. Tel: 01179 200 070. Fax: 01173 179 493. E-mail: enquiries@mchattie.co.uk. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form by any means, electronic, mechanical, photographic, or otherwise without the prior permission of the copyright holder. Authorised and Regulated by the Financial Services Authority.

## NEW COVERED WARRANT ISSUES

SG issued nine new turbos on 6<sup>th</sup> October, all with maturity dates lasting into December. The new long turbos were issued on the **FTSE 100 Index, Dax Index, CAC 40 Index**, and on **Anglo American**, but six of them were knocked-out almost immediately on their first day of trading, and the remaining three were knocked out two days later. This says a lot, we think, about the level of risk attached to these turbo products in these highly volatile markets. If the turbos hit their knock-out levels they expire worthless, and right now the risk is obviously very high that this will happen. We think we would find it very hard to recommend these products until market conditions calm down: instead we would approach them with extreme caution. In our view it is better to stick with warrants for the moment, where there is no risk of being 'stopped-out' of a position after a price spike or a violent short-term movement which is quickly reversed.

On 14<sup>th</sup> October SG issued a large tranche of 60 new warrants, on **Anglo American, Antofagasta, AstraZeneca, Aviva, Barclays, BG Group, BHP Billiton, BP, British Airways, BT Group, Lloyds TSB Group, MAN Group, Prudential, Royal Bank of Scotland, Tesco, Xstrata, Yell Group**, and the **FTSE 100 Index**. The idea was obviously to issue warrants with more realistic strike prices, but of course the continued market falls soon rendered many of these new call warrants deeply out-of-the-money as well. At the same time, SG issued a tranche of five new turbos on the **FTSE 100 Index**. One of these, the **T123** series, has a strike price and knock-out level of 3200, so we would hope that one is reasonably secure from an early knock-out at present.

On 24<sup>th</sup> October, SG issued 27 new warrants on market indices, namely the **Dow Jones Industrial Average, Nasdaq 100, Nikkei 225, S&P500, DAX Index**, and **Eurostoxx 50 Index**. All of these new warrants have expiry dates running to June or September 2009, so they have a good amount of time to perform. On the same day, SG issued seven more turbos, these ones on **Anglo American, GlaxoSmithKline**, and **Vodafone**. Finally, on 29<sup>th</sup> October, SG issued six new warrants on the **FTSE 100 Index**, with significantly lower strike prices. The issues included, for example, the **SB01 FTSE 100 4000 19-Dec-08 call**, which seems reasonably conservative to us. With the FTSE having rallied to 4192 at the time of writing, these warrants at 49.5p still offer leverage of 5.3 times with a reasonable delta of 0.62. In CFP terms the warrants betray their high implied volatility of 63.6% - the CFP works out at 75.73%, which does look high. The risk of time value decay is significant. Even so, we do think these warrants could produce a good return if the market rally is sustained – they are ONES TO CONSIDER.

The launch event for the new Royal Bank of Scotland covered warrant platform was held in London last week, with Andrew McHattie and Jim Rogers as the guest speakers. RBS has not yet issued any warrants though, as it needs to wait until the company has issued a new prospectus, relating to the government refinancing. This should happen very shortly, and RBS estimate that 5<sup>th</sup> November might be their actual launch date.

We have plenty of new information though about the proposed warrants. RBS plans to issue "a couple of hundred" warrants on a good range of underlying assets, including some new ones. There will be warrants, for example, on the Brazilian **Bovespa Share Index**, and on the **Rogers International Commodity Index**, developed by Jim Rogers. The style of the warrants will also be different from those we have seen before. RBS recognise the huge spike in volatility which has occurred of late, and which makes derivatives much more expensive. The VIX Index, which measures market volatility in the US, stands at record high levels, and this – other things remaining equal – makes covered warrants expensive because volatility is a key input into the pricing matrix.

RBS hopes to address this problem by issuing longer dated warrants with intrinsic value, which are less susceptible to volatility as an input. The worry otherwise is that all warrant prices will fall significantly as volatility eventually moderates to more normal levels. As a result we can expect some two-year covered warrants pitched around 30% into-the-money, which sounds good to us. The downside is less gearing, but this slightly more conservative style of covered warrant is what we have been seeking for a long time. We look forward to their imminent arrival. To find out more, we recommend a visit to the RBS website at <http://www.rbs.co.uk/markets> - it has plenty of information online already. You will be able to see the details of all of the bank's products, and use the RBS online calculator which works in a similar way to the 'scenario selector' tool on the London Stock Exchange website. You can tap in your forecast for an underlying asset on a particular date, and the RBS calculator will give you an idea of how warrant prices would change. There is also an educational academy and some other elements which you can discover by clicking on links on the site.

We are keenly awaiting the first RBS covered warrants, which will be with us very shortly. The bank has given every indication that it plans to be a serious player in this market, devoting plenty of time and resources to ensuring investors have good products with which to invest, protect, and diversify.

## COVERED WARRANTS IDEAS

Covered warrant trading hit a new peak for September – the last month for which we have the data – so at least some investors have been using their flexibility to take positions in these tricky markets. By a large margin as usual, it has been **FTSE 100** warrants which have been most widely used. On the put side, the most actively traded warrant of all has been the **SH32 FTSE 100 6000 19-Dec-08 put**, as was the case last month. Some investors did favour the **SV91 FTSE 100 5700 19-Dec-08 puts** with a lower strike price as the market came down. On the call side, we were surprised to see that the **SQ31 FTSE 100 5200 19-Dec-08 calls** had remained popular in spite of a very low delta of 0.10. This means that the warrants are unlikely to reflect movements in the FTSE 100 Index very faithfully, and that there is a strong (90%) chance of the warrants expiring worthless. That does not seem a good combination to us, so we would rate those warrants a SELL and suggest that holders move into one of SG's newer warrants with a lower strike price.

Outside of the FTSE 100, investors have also been trading positions in the **FTSE 250 Index**, which has underperformed the FTSE 100 significantly over the last month. The index stands at 5973. The most popular play here has been the deep in-the-money **SQ30 FTSE 250 10,000 19-Dec-08 puts**, which offer leverage of just 1.4 times now, but with a very high delta of 0.96. There has also been some trade in the **SQ29 FTSE 250 9000 19-Dec-08 puts** which seem a more sensible choice in our view with leverage of 1.8 times and a delta of 0.91, which is still very high. On the **Dow Jones Industrial Average** there has been a reasonable amount of trade in the **SL15 Dow Jones 11,000 19-Dec-08 puts**, which have more than trebled in value over the month. We are not so sure that the Dow Jones warrant favoured on the call side is the right choice. The **SV13 Dow Jones 12,000 19-Dec-08 calls** at 1.07p are highly speculative with leverage of 11.9 times but a delta of just 0.02. Again, we think investors would be better off now by switching attention to a call with a lower strike price (and perhaps a longer date as well), such as the **SH69 Dow Jones 10,500 19-Jun-09 calls**.

Turning now to individual stocks, there has been some trade in a variety of different company warrants. These have included the **SR63 Next 1200 19-Dec-08 puts**, the **SQ81 BP 750 18-Dec-09 call** warrants and the **SQ80 BP 600 19-Dec-08 calls**, the **SU35 Lloyds TSB 250 20-Mar-09 calls**, and the **SR43 Kingfisher 120 19-Dec-08 puts**. The range of different warrants traded reminds us that it is possible to back a wide variety of opinions using covered warrants.

One sector we wrote about last month, and which we still think has the scope for excellent profits is pharmaceuticals. As investors seek out more defensive earnings, we think this is one of the areas which could attract an increasing amount of interest. **AstraZeneca** has displayed some resilience, helped by more good product news. The company has received clearance from the FDA for its bipolar depression drug Seroquel to be used for long-term treatment. AstraZeneca shares have risen from a base of around 2100p in June to around 2400p in late October (although they have been higher in the interim), helped by a number of broker price target upgrades. Citi, for example, has raised its share price target from 2582p to 2700p. The **SQ60 AstraZeneca 2200 19-Dec-08 calls** have dropped slightly over the month from 41.6p to 37.9p. Britain's other drug giant, **GlaxoSmithKline**, has also recovered some of the value it has lost since 2005. From a low of 987p in March, Glaxo has rallied markedly, up to a peak of 1327p at the start of September, and settling at 1166p now. The stock has been helped by the strength of the US dollar, and by news that the EU has cleared the company's weight loss drug Alli for sale over the counter. Glaxo said the medicine for overweight adults could be launched across all 27 EU countries as the first weight loss treatment available without a prescription. This was welcome news, and might encourage the shares to add a few pounds in due course. The **SV27 GlaxoSmithKline 1100 19-Dec-08 calls** at 13.45p offer 5.4 times leverage with a delta of 0.63.

There has been a huge and unseemly rush out of sterling. Comments by both the Bank of England governor Mervyn King and also by Gordon Brown that Britain is entering recession deepened pessimism over the country's economic prospects, and then the GDP data released last Friday provided the final blow. The rate did dip at one stage to below US\$1.55, but it has since rallied to US\$1.64 as investors anticipate interest rate cuts in the US. The **SW49 GBP/USD 1.70 20-Mar-09 put** warrants are still up massively over the month, and the **SX88 GBP/EUR 1.15**

**Dec 08 puts** have similarly posted a good rise. In the very short-term, the US dollar has perhaps lost some of its momentum against sterling, and anyway it might seem counter-intuitive for America's currency to be strong at a time when its financial system is in such a mess. What has been happening though is that investors have been buying dollars to repay borrowings as the world unwinds its leverage, and domestic US institutions have also been repatriating assets as their risk appetite falls. This has been positive for the dollar. At the time of writing its outlook is difficult to forecast, as the Federal Reserve is about to make an announcement on interest rates. Economists expect the Fed to cut its key funds rate by a half percentage point to 1% at the conclusion of the Federal Open Market Committee's two-day meeting, but some even predict a cut to 0.75%, which would mark the lowest level for the fed funds rate in its 53-year history. Some analysts have speculated that the Fed's announcement will come as part of a coordinated rate cut by many central banks around the globe. We'll have to see what happens, but certainly we can expect more action from the dollar over the coming days and weeks, so it might be worth keeping an eye on some currency warrants. For a stronger dollar, we would track the **SX55 EUR/USD 1.40 19-Dec-08 put** warrants, currently 77.25p; for a weaker dollar the choice is not so obvious.

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## LEVERAGED ETCs

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We said last month, reporting on the difficulties ETF Securities had suffered with its AIG-backed leveraged ETCs, that the company would "need to re-think its business model, and create new products with less in the way of credit risk." It has indeed acted quickly and done exactly that. On 21<sup>st</sup> October ETF Securities announced that all of its ETCs would now be backed by collateral, held by a third-party collateral manager. This is a welcome move, and puts the company's leveraged ETCs on to a much firmer base now, in our opinion. We understand that some investors may still prefer to avoid products with counterparty risk altogether, but in this case we do believe the collateral backing effectively removes this as a potential problem. Leveraged ETCs may just emerge from this crisis as a better and stronger product than ever before.

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## CORPORATE WARRANTS FOR RECOVERY

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It may or may not be too early to be looking for warrants for recovery. We don't know. We thought though that readers are bound to be asking this question: IF I do think the market is turning, which warrants are the ones to consider? When considering warrants for recovery, it seems far too simple to us to see which warrants have fallen the most. Many warrants will never recover, we suspect, because their underlying shares have now fallen too far away from their fixed exercise prices to make recovery a realistic proposition. Other warrants are just too short-dated, and do not allow sufficient time for a good profit to be generated. With this in mind, we ran a couple of simple filters over our investment model, aiming to create a shortlist of warrants to watch.

We started with a measure of intrinsic value, or parity. Some share prices stand very little chance of ever reaching the exercise price of the warrants. On this basis we eliminated all warrants with a parity ratio of less than 0.4: in other words where the underlying share prices were less than 40% of the strike prices. This knocked out a third of our universe straight away, with the worst examples including **Prospect Epicure J-REIT, NextGen, Aricom, CEC Unet, Strathdon Investments, Astek Group, Infinity Bio-Energy, Clean Energy Brazil, Messaging International, Twenty, Thor Mining, and Antonov**. Next, we knocked out any warrants with relatively short dates to expiry, and filtered out those with very high CFPs. We then knocked out a couple of warrants with known liquidity issues (including **Infrastructure India**) or where there are special factors (for example, **British Energy**). This reduced the list to a dozen. Our final filters were to eliminate those with the lowest gearing, and also those which had only suffered relatively small declines in the market sell-off over the last three months.

The result was a final list of five warrants which have reasonable technical positions, which have fallen heavily over the last six months, but where the parity ratio and time to maturity indicate sufficient scope to allow recovery. Let's take a look at each in turn. First up is **3i Infrastructure** at 9.5p, and down by 55% over the last quarter. The underlying trust has a very sound portfolio, we think, invested in reliable high-quality assets, and is likely to survive even a protracted downturn. The shares stand at 87% of the strike price of 100p, which looks reasonably comfortable with a final maturity date of March 2012. The warrants trade with gearing of 9.2 times for a CFP of 7.85%, which looks very reasonable.

Our second choice is a little esoteric. **Elephant Capital** (formerly Promethean India) warrants at 11p are down by 31% over the last quarter, and offer gearing of 8.4 times for a CFP of 12.95% at the current price. The shares stand at 92.5p, some 74% of the 125p exercise price, and

the warrants have a final expiry date in April 2012. Those are the bare facts. The company invests in private and public equity investments in India and is advised by an India-based investment team. Four investments have been made to date across a range of sectors including leisure, automotive, mobile payment services and building materials, and investors will hope that these have been chosen wisely. We think that India will eventually emerge from the current crisis with its attractions intact, ready for another period of robust growth. Against this background, Elephant Capital warrants have a decent chance of recovery, we think.

Third, **Ludgate Environmental** warrants at just 6p have lost 71% of their value over the last three months, so they have plenty of lost ground to recover. The underlying shares at 100.5p stand at 67% of the 150p strike price, but the warrants have a good long life to 31<sup>st</sup> October 2012 for the shares to rise. As at 30<sup>th</sup> June, the trust's net asset value per share was 120.24p, having posted a good rise during the trust's first year of operation. We'll have to see how Ludgate copes with these tougher market conditions, but its environmental and cleantech sector does have some independent impetus which might help to see it through. The warrants currently offer gearing of 16.8 times for a CFP of 12.22%.

Our penultimate choice should come as no great surprise - it is **Perpetual Income & Growth** subscription shares, which have fallen by a little over a quarter over the last month. The underlying trust is conservatively managed by Mark Barnett at Perpetual, who is a highly regarded manager. The stockbroker WINS issued a research note on the trust on 6<sup>th</sup> October. It explained that Mark Barnett of Invesco Perpetual manages this fund through an active, unconstrained approach which seeks to achieve absolute returns with little regard to benchmark weightings. He can deviate significantly from the index, depending on his view. His outlook for the UK economy – as it has been for some time - is bleak with growth prospects deteriorating as a result of the consumer slowdown, deflation in the housing market, and stretched government spending. Reflecting these macro views, the trust's current focus is on defensive growth companies, particularly non-cyclical businesses that offer good earnings visibility and growing dividend streams. Mark's outlook on the UK equity market is cautiously optimistic with valuations seen as reasonable given dividend yields of around 4.5% and a P/E ratio of 11x. In the manager's view, large cap companies are particularly attractive. He regards them as higher quality holdings, often providing double-digit dividend growth, stronger balance sheets and more defensive characteristics. The portfolio has 77% of assets in the FTSE 100, 15% in the FTSE 250, and just 3% in the Small Cap, with the remainder invested outside the All-Share. The portfolio has a strong defensive focus with 17% in utilities and there is no exposure at all to banks, reflecting the manager's view on the UK economy and consumers, and no exposure to property related stocks or housebuilders. This has obviously helped recent performance. Overall, there are 65 stocks in the portfolio. Recent investments include ITV, UK Coal, AstraZeneca and Informa. Up to 10% of assets can be invested in stocks listed outside the UK, and currently there is one US tobacco stock, Reynolds American (4.8% of the portfolio). Equity exposure is currently 114% of net assets which is a reflection of opportunities in stock selection, rather than a top down view on market movements.

The trust's long-term performance record is strong with the net asset value up 89% since Mark became manager in July 1999, compared with 11% for the FTSE All-Share. The trust underperformed the technology-led rally in 1999/2000 due to the manager's refusal to chase growth stocks, but subsequently performed well in both the difficult market conditions of 2001/2003 and the strong market recovery that followed. One of the key elements for this was the overweight position in mid cap stocks. Between 2005 and 2007, the fund's performance was broadly in line with the benchmark as the manager became more cautious and repositioned the portfolio towards mega-cap defensive holdings by reducing exposure to the mid cap. In the last twelve months, the net asset value is down 19% compared with 25% for its income growth peers.

WINS rate Mark Barnett highly and believe that his emphasis on defensive growth companies looks suited to current market conditions, although if there is a significant re-rating in the bank sector, this trust will underperform. "However", they conclude, "we believe that his investment approach, unconstrained by benchmark weightings, has the potential to provide attractive returns over the long term." The subscription shares have a life running until 31<sup>st</sup> August 2013, which should provide enough time for a turn in markets. We certainly hope so, and if markets do rally then these securities at 28p are WELL POSITIONED with gearing of 6.6 times for a CFP of 7.08%. The underlying trust shares stand at 85% of the strike price, so we don't think it is asking too much for them to recover and for the warrants to re-gain some intrinsic value.

Our final choice for this mini-portfolio is **RCM Technology Trust**, where the subscription shares at 12p have suffered a 45% loss over the last month, and a have given up more than 60% of their value over three months. RCM Technology shares have fallen back to 181p, which is 68% of the subscription shares' strike price of 267p. The final expiry date is April 2012, and at current prices the subscription shares offer gearing of 15.1 times for 14.18%. This is possibly the most speculative of our five choices, but the risk seems acceptable within the context of a portfolio.

We like RCM Technology, and can see a better future for the trust. It has performed well against its peers in the past, and technology can be a key driver as economies come out of recession and companies battle for competitive advantage.

Right now, Walter Price, the manager of the trust, reckons that alternative energy is a likely beneficiary of the US Presidential Election race. There are some problems to overcome first, though. Walter says "the most important issue for the technology sector and the world is the need to restore the effective functioning of the financial markets. Business has already been affected since the middle of September, when the bankruptcy of Lehman Brothers sent shock waves through the debt markets and caused short term debt and commercial paper to become much harder to obtain. Technology projects and expenditures that can be postponed are being so, both by consumers and companies. Although many companies have made expectations for the September quarter, we expect that forecasts for the December quarter will be lowered and those that dare talk about 2009 will do so with tempered expectations." This squares with the anecdotal news we have heard from practitioners in the US, who say the business background is very weak, with budgets for all kinds of spending currently being slashed.

Walter continues "in terms of the political background, the platforms of the incumbent Republican president, Bush, and the leading Presidential candidate, Democrat Obama, are quite different. Obama believes in the beneficial effects of government policy, and this should matter in a number of areas relevant to technology. For instance, Obama has pledged to address Global Climate Change and the need to eliminate the dependence of the USA on foreign oil imports. We should see a programme that builds upon the Investment Tax Credit (the package of tax measures designed for the solar energy sector) that was passed by Congress as a part of the rescue bill to encourage alternative energy generation, including new credits for electric, hybrid, and natural gas run cars and trucks; more funds for research into new energy sources; and credits for energy conservation efforts. We think this will spur the wind and solar industries in the US to become the largest in the world, but there will be a bias for those companies that locate their plants in the US and employ lots of US citizens. Companies like First Solar, Sun Power, and Energy Conversion Devices will be beneficiaries. It will also give impetus to the conservation technologies of companies like Itron." In more general terms, Walter says "Obama is also a supporter of reforming the income tax system, to provide additional income for those making less than \$100,000 and additional taxes for those making over that level. We could see a tax cut for most Americans passed as early as November, which would help soften the recession now under way in the US. This would help many of the technology companies making computers, as this fits into the effort to improve the educational strength of the US. We would expect to see broader internet availability."

It is good to have Walter's view, and to note that he can see some positive moves for technology in the future. The life of the subscription shares is just about long enough, we hope, for another technology cycle to have begun, and for Walter to have identified some of the best winners.

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## CORPORATE WARRANTS NEWS

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The new subscription shares from **Advance Developing Markets** began trading on 22<sup>nd</sup> October. Of course by that time the share price was considerably lower than the 330p we recorded in the last newsletter, and the trust's net asset value was a lot lower than 371p. By the time of the calculation on 21<sup>st</sup> October, the net asset value per share was 290.03p, so the subscription price was set at 291p. A total of 13,020,168 subscription shares were issued to shareholders on a 1-for-5 basis. The subscription shares started trading at 50p, bang on the price we expected, but the mid-price has since dropped back to 30p as the market has fallen. With the shares down by 32% over the month to 225p, the subscription shares currently offer gearing of 7.5 times for a CFP of 14.25%. This does not look cheap, and we do not like the 25p-35p dealing spread either, so for the moment we would say it might be best to look elsewhere for a bargain.

The Anglo-Russia mining stock **Aricom** has felt the full force of the icy winds blowing through commodity markets right now. Its shares have slumped by 78% over the last month, down to just 5.23p. This leaves the warrants' 80p exercise price looking like a distant dream. Unfortunately the warrants seem unlikely to fulfil any useful function, having earlier looked to have great potential. The Canadian oil & gas company **Bankers Petroleum** has also failed to impress the market with an operational update showing a third quarter exit production rate exceeding 6200 barrels per day. In spite of some very reasonable figures from Bankers, its shares have still sunk by 62% over the month, leaving the warrants, down 45% at 55p, looking OVERVALUED and unlikely to achieve value.

Many warrants now look overvalued. A couple we'll mention because subscribers might have old legacy holdings are **Blue Planet Financials**

**Growth & Income** (capital fulcrum point 1282.37%) and **City Natural Resources High Yield** (CFP 80.27%). Both look well over ripe for a fall and are rated a SELL. We would also hold off for the moment from purchasing any warrants on **Impax Environmental**. The warrants at 27p have held up quite well, but as a result they now look EXPENSIVE against their underlying shares, with gearing of 3 times for a CFP of 42.82%.

We have searched fruitlessly for some kind of timetable update for the takeover of **British Energy** by EDF. Perhaps there will be some kind of update with the company's interim results announcement on 18<sup>th</sup> November. In the meantime the company – for what it is worth – has provided some updates on its output and on the closed reactors at Hartlepool and Heysham. British Energy says that repair work is “progressing well but is slightly behind schedule.” This is no great surprise, and it does not impact the warrant valuation, which is already set in EDF's offer. We still think that warrant holders should sit tight and WAIT for the cash payout.

The Brazilian ethanol investor **Clean Energy Brazil** has announced a dreadful set of results and announced that it needs more cash. The results for the year to 30<sup>th</sup> April, released on 27<sup>th</sup> October, made for grim reading. The company has raised more than US\$200m for investment from its flotation in December 2006, followed by a secondary fund-raising a year later, but it will now need to come back for more. The problem lies with the Usaciga Group, in which Clean Energy Brazil invested US\$127m. Usaciga has tried to expand, beginning with the modernisation of its mill in Cidade Gaúcha in the state of Paraná. The company has improved the mill's productivity, and it recorded positive results in the 2007/08 crop season with a net profit of approximately US\$5.7m and EBITDA of US\$13.4m, as opposed to negative results in the previous season. With 1.9m tonnes of sugar cane crushed in 2007/08, the company expects double digit growth in sugar and ethanol production for the 2008/09 crop year. Moreover, a major investment in co-generation was completed in October 2007, which facilitated the commencement of supply to the National Energy Grid of 36,000 MWh/year in the 2007/08 crop season. So far, so good. The second project at Usaciga is the Rio Paraná greenfield site in Eldorado, Mato Grosso do Sul State. Usaciga has continued to advance the development of this site, which includes approximately 9000 hectares of plantation, and progress has been made with the construction of the sugar mill site. However, due to tightening credit markets, Usaciga has not raised sufficient funds for the completion of this development, and the capital expenditure involved in the development to date has resulted in a significant working capital shortfall and a delay in its opening. Accordingly, Usaciga now needs to raise funds in the short-term to meet its financial obligations. Construction has been stopped at Rio Paraná until a financial solution can be found. Various potential sources of funding are being considered by Usaciga's management in conjunction with its co-owners, Clean Energy Brazil and the Barea family. In light of the above, Clean Energy Brazil has taken the prudent decision to write down the value of this asset to an estimated fair value of US\$50m, or less than half of its original investment.

Clean Energy Brazil also invested US\$37m in Unialco, a company controlling the fully operational Alcoolvale mill, and a greenfield project under construction in Dourados, in the state of Mato Grosso do Sul. Alcoolvale started its 2008/09 crop season in early April 2008 and has been operating up to the end of September 2008 with more than 87% efficiency, having crushed more than 1.2m tonnes of sugar cane by that time. However, the process of securing debt financing for the capital expenditure required for the development of Dourados, which has a planned annual crushing capacity of 2.5m tonnes, has not been completed yet. The delay in securing this funding is expected to result in an estimated 12 month delay in commencement of operations from the originally planned 2009/10 crop year.

Finance problems are therefore troubling both of CEB's main investments, and they have not been helped either by significant increases in production costs, arising mainly from weakness in the US dollar and higher oil prices. While these costs have peaked, the prevailing realisation price and production costs for the current crop season (2008/09) are still expected to result in CEB's companies not performing as well as in the last crop season. Clean Energy Brazil has halted its dividend, and says its immediate aim “is to resolve its current challenges which have coincided with difficult conditions in financial markets and the Brazilian sugar sector.” The company concludes “we are facing and resolving current challenges and have engaged Merrill Lynch together with Numis as advisers on a capital raising to support our business plan.” Investors can hope for some better news from the company and its advisers, but unless and until the shares at 12.5p receive some support, we think the warrants are effectively OFF-LIMITS for investment.

The latest news from **Close Enhanced Commodities** does not make for comfortable reading. Straight after last month's newsletter was published, the promises made by the Icelandic government over the debts of its banks became impossible to sustain. Glitnir Bank has subsequently been put into receivership, and Close Enhanced Commodities has addressed this question in its half-yearly financial report, issued

on 22<sup>nd</sup> October. The trust says that one of its six debt securities was issued by Glitnir, and that this accounts for approximately 19% of the total nominal value of the company's debt securities. The manager and the board of the company consider it likely that Glitnir may not pay in full on its obligations. They add "whilst recovery rates from issuers that default vary, and in this case are currently unknown, the worst case scenario would see the company receive nothing at the maturity of the relevant debt security." This means that it might be necessary to slice almost 20% off the final capital entitlement for shareholders, which is a harsh blow. Based on the commodity values ruling on 22<sup>nd</sup> October, the projected final capital value at that time was 170p. Deducting 20%, to give us the worst-case projection, brings this down to 136p. Against this, Close Enhanced shares at 105p are trading on a 22.8% discount, which does not seem unreasonable now. This has been a sorry episode for the trust, and a hard-to-swallow lesson in counterparty risk for its shareholders. For the moment it seems reasonable to value the Glitnir debt securities at zero, in which case we think the current share price is only FAIR VALUE. We are not aware of any similar issues, by the way, at the sister trust **Close Enhanced Commodities 2**, where the ordinary shares are again geared.

Very few corporate warrants look great candidates for recovery bets. Many have either not fallen far enough, or they are too far distant from their exercise prices. One which does look a reasonable bet though is **Finsbury Worldwide Pharmaceutical**. The warrants were too short-dated, running until the end of next July, to make it into our recovery portfolio, but they stand out on technical grounds. At 40p the warrants offer gearing of 12.3 times for a CFP of 4.00%, which looks extremely good value. Furthermore, the warrants are still (just) in the money, with 26.5p of intrinsic value, and the warrants run until the end of next July. We might prefer to have more time remaining, and it will not take very much at all for the remaining 26.5p of intrinsic value to evaporate, but nevertheless we think these warrants are AS WELL POSITIONED AS ANY FOR RECOVERY.

The issue of subscription shares by **JPMorgan Indian** is just a few days away now, so we'll take the opportunity to recalculate our sums. The shares have dropped over the month from 284p to 223.75p, and according to the trust's latest NAV announcement, the net asset value per share is 232.16p. based on this figure, the relevant exercise prices would be 235p, 256p, and 302p. Our model now suggests a figure of 35p as offering fair value, with gearing of 6.4 times for a CFP of 9.50% at the longest exercise period. This equates to 7p per share. We'll see how the price opens on Wednesday, and hope that the market-makers do a better job than they have done so far for the **JPMorgan Chinese** subscription shares, which have always suffered from a wide dealing spread.

The sorry tale of woe at **Prospect Epicure J-REIT**, which we have covered periodically, has taken a few more turns for the worse. One of the trust's holdings, representing 2% of assets, has declared bankruptcy, and at the start of October the trust was forced to sell down a number of its assets as its prime broker reduced the gearing available to the trust. Cash was used to meet margin calls, including the cash earmarked for the interim dividend, which the trust says is very unlikely to be paid. This trust finds itself in a grim situation in a grim market, in which it is being forced to sell its already bombed-out assets. Little wonder the shares are down by nearly 90% over the month, down to a tiny fraction of the warrants' exercise price. We think we can say that the warrants have effectively no chance of ever achieving value. AVOID.

We are not sure how useful it is for us to report extensively on the news at **York Pharma**. The company's shares, down by 11% over the month to 16p, need to more than treble by February if they are to reach the warrants' exercise price in time. That looks extremely unlikely. For what it is worth, we rather liked the company's latest announcement on 28th October that it had acquired certain of the assets and the continuing business of Celltran Limited from its administrators at "a compelling valuation." York explained that to date, approximately £15m has been invested in the Celltran portfolio of products. The acquisition expands further York Pharma's product offering in dermatology, providing two specialised, marketed products for the treatment of chronic wounds and burns, Myskin and Cryoskin, and a rich pipeline of associated products and technologies. Concurrently, an institutional placing led by FinnCap has raised £510,000 (before expenses) at 14.4p per share to provide additional working capital for the integration, operation and further development of the assets within York Pharma's business. York is only paying £70,000 up-front for the deal, plus the payment of royalties on future sales for a period of five years. It expects the deal to be self-financing within a year following acquisition and to provide a growing income stream to York Pharma during that period at no incremental sales team costs. We might see many more deals of this nature over the coming months as some smaller companies fail – this can work to the advantage of the larger players. Unfortunately we doubt whether the gains will be sufficiently dramatic to rescue York Pharma warrants from a worthless demise. The main hope for the warrants at 1.5p is that the company extends the exercise date.

**Your next newsletter is published on Saturday 29th November.**