

# Warrants Alert

INDEPENDENT ADVICE ON UK WARRANTS - PUBLISHED SINCE 1989

NOVEMBER 2004

## MARKET COMMENT

We are always on the lookout for interesting views and opinions on the markets, if only to stimulate our own thoughts. One headline caught our eye, from the *Motley Fool* website, which trumpeted, "FTSE to hit 6289 In 2005." Wouldn't that be welcome. The article, by Maynard Paton, argued "booming company profits and a bargain price to earnings (P/E) ratio make this market a buy." He says that earnings from Britain's top 100 businesses have surged a massive 32% in 2004, and that the P/E ratio on the index has dropped from 17.53 at the start of the year to 14.52 now. There have been just two other occasions in the last ten years when the index has traded on a lower P/E, the article explains. The first was in July 1996, when the P/E for the FTSE 100 Index averaged 14.40. At the low, when the index hit 3632 on 16<sup>th</sup> July 1996, the P/E was 14.02. One year later, the index had rallied to 4964 - a gain of 37%. The second instance was on 13<sup>th</sup> March 2003. At the bottom of the bear market, the FTSE 100 hit 3287 and registered a P/E of 14.43. Twelve months on, the index had rallied to 4,467 - a gain of 36%.

Maynard says "if market P/E history is any guide, a 36% rally during the next twelve months seems a genuine possibility." He says "don't be surprised to find London's leading index at 6289 by Halloween 2005." Actually, we would be surprised, but this is an interesting piece of research which accords with many other items we have been reading. Conditions for UK blue-chips are actually quite good at present, and earnings growth is attractive. If you believe the market could be set for a really substantial rally, the covered warrants market provides plenty of choices. All five warrant issuers in the UK have FTSE 100 call warrants available, with a range of strike prices and maturities. Two which stand out from our analysis as offering good value are the **J048 JPMorgan FTSE 100 4500 17/06/05 calls** at 37.05p, offering leverage of 9.85 times for a premium of 3.31% and CFP of 5.88%; and the **G682 Goldman Sachs FTSE 100 4250 18/03/05 calls** at 54.05p, offering leverage of 8.12 times for a premium of 1.61% and a CFP of 5.03%.

## RISERS AND FALLERS

Major Price Rises Over the Month		Corporate Warrants	
Covered Warrants			
GS Google 105 calls (G736)	+263.07%	Investment Trust of ITs	136.8%
GS W M Morrison 200 calls (G712)	+258.08%	Cheerful Scout	114.3%
GS W M Morrison 250 calls (G713)	+253.49%	Blue Planet Financials	47.8%
GS Google 110 calls (G734)	+240.80%	Azure Dynamics	36.4%
GS Unilever 575 calls (G633)	+240.00%	Namibian Resources	32.1%
GS Reuters 350 calls (G719)	+185.51%	Merrill Lynch World Mining	28.1%
TL Abbey National 650 calls (T349)	+177.62%	Fidelity Asian Values	27.8%
JPM Shell 500 calls (J088)	+176.39%	City Nat Res High Yield	26.7%
GS Gold 425 calls (G751)	+173.94%	Deutsche Latin American	16.7%
GS WPP Group 550 calls (G658)	+172.52%	Schroder Japan Growth	16.7%
GS BSkyB 650 calls (G643)	+160.00%	SR Europe Inv Trust	16.1%
DKW Nasdaq 100 1600 calls (D024)	+155.32%	F&C Latin American	14.4%

FTSE supported by good earnings growth; new covered warrants on commodities, currencies, and now on hedge funds; AstraZeneca helped by US election result; British Airways troubled by high oil price; Man Group shares rise on takeover speculation; mmO2 shares rise; Prudential shocks market with rights issue; analysts take positive messages from Vodafone investor day; Google shares rise dramatically as institutions buy in; Nikkei 225 Index bounces off bottom of trading range again; interesting new issues from Finsbury Worldwide Pharmaceutical Trust, SubSea Resources, and ADDleisure; Cheerful Scout rises on positive news; developments at Deutsche Latin American; York Pharma keeps rising.

NEW! [www.itsbox.co.uk](http://www.itsbox.co.uk)

### Major Price Falls Over the Month

#### Covered Warrants

GS Brent Crude 12'04 puts (G748)	-94.33%
GS Google 95 puts (G733)	-94.12%
TL FTSE 100 5400 calls (T172)	-92.98%
TL FTSE 100 3600 puts (T164)	-90.03%
GS Nasdaq 100 1200 puts (G558)	-88.54%
TL FTSE 100 3900 puts (T165)	-88.22%
GS Ebay 75 puts (G572)	-87.57%
GS GBP/USD 1.7 puts (G669)	-87.04%
GS Reuters 300 puts (G720)	-86.81%
GS Irish Blue Chip Bkt puts (G907)	-86.42%

#### Corporate Warrants

Baillie Giff Shin Nippon	-45.2%
Jourdan	-37.0%
Invesco Japan Discovery	-35.7%
Planestation	-30.6%
Crown Corporation	-25.0%
betinternet.com	-22.2%
Marconi	-22.0%
London & Boston Invs	-14.3%
Marakand Minerals	-12.1%
Westside Acquisitions	-10.0%

## NEW COVERED WARRANT ISSUES

Since the October newsletter we have seen a number of new issues. Firstly, Goldman Sachs issued 22 new covered warrants, including two **volatility index** certificates – one call and one put. The warrants were on commodities and currencies, with two new issues of call warrants on each of **palladium** and **platinum**, extending the coverage of precious metals in the covered warrants sector. The range of currencies was also extended, with the addition of both call and put warrants on the **sterling/Australian dollar** exchange rate, and on the **sterling/South African rand** rate. Goldman also extended the coverage of the **oil** market with call and put warrants on the June 2005 Brent Crude futures. SG followed up about a week later with a new issue of call and put warrants on both the March 2005 and the June 2005 Brent Crude price.

At the end of October, Dresdner Kleinwort Wasserstein issued a rather intriguing new structured product. The hedge fund sector is a mysterious one, and is often inaccessible to private investors due to poor liquidity and high minimum investment levels which can stretch into tens of thousands of pounds. To help retail investors gain access to this sector, Dresdner has issued a certificate based on the **HRFX Global Hedge Fund Index**, compiled by Hedge Fund Research (HFR), a US-based organisation which tracks the hedge fund sector. HFR launched the HFRX Global Hedge Fund Index on 1<sup>st</sup> April 2003 with an opening value of 1000. The index is structured in such a way that it tracks the performance of the global hedge fund investment universe with reference to the HFR database. The index is calculated from all hedge funds in eight sub-indices, each of which is designed to represent the main hedge fund investment strategies. The strategies are: Arbitrage, Securities, Equity Hedge, Market Neutral, Event Driven, Macro, Merger Arbitrage, and Relative Value. These eight strategies are weighted in the index as per the capitalisation of the various hedge funds represented in the respective indices. At present the index comprises 63 components, which are all listed in US dollars. The weightings of the eight sub-indices are rebalanced on the basis of information in the HFR database, which is designed to represent the entire hedge fund universe. The index is currently trading at 1101.06, down 0.48% over the year, but up over 10% since its launch in April last year. The **D092 DrKW HRFX Global Hedge Fund Index long certificates** are trading now, and have the usual advantage of tracker certificates in that the costs involved are generally lower than tracker funds. With no stamp duty on trading, we think they make an excellent instrument to obtain general access to the hedge fund industry.

## COVERED WARRANTS ON UK COMPANIES

**ARM Holdings** expects to achieve revenue growth of 20% next year as the UK chip designer's ARM11 products continue to gain popularity with semiconductor makers, according to chief financial officer Tim Score. "The market numbers for 2005 are for growth, in sterling terms, of around 20% and we see no reason to change that at this stage," said Score in a conference call with analysts. The group's ARM11 designs — used in next generation mobile phones, digital cameras and other wireless devices - would underpin growth in 2005, according to Score. "The initial ARM11 license growth was driven by leading-edge wireless semiconductor companies, but it is fast becoming a mainstream product," said Score. Score's comments came as ARM reported slightly better than expected results for the third quarter, during which it signed five licenses for its ARM11 designs. "ARM11 licensing is making very good progress and royalty growth is all about penetration into markets other than just

mobile handsets," he added. ARM licenses its technology to chip makers, who pay a one-off licensing fee; it then receives a royalty payment each time a device based on its technology is sold. The upbeat forecast has helped lift ARM shares by 17.86% to 99p over the month, which in turn has propelled the **G724 Goldman Sachs ARM Holdings 80 18/03/2005 call** warrants 76.08% higher to 22.45p. At this level they offer leverage of 3.83 times for a premium of 3.48%. The delta is 0.87.

Shares in UK pharmaceutical blue chips could be lifted by the news, as we write, that George Bush will be returned to the White House, and amid positive broker comment. A Republican win is likely to lift sentiment in the sector as market watchers fretted that Democratic challenger John Kerry would push through plans to cut drug prices in the US. Investors also feared that Kerry might favour importing cheaper drugs from outside of the US, knocking hefty profits off industry sales in the US – the world's biggest pharmaceutical market. According to Morgan Stanley, a Bush victory represents a clear positive for the drug sector. In a note to clients, it argued Bush's administration would create a positive environment for private delivery of the prescription drug benefits, and the threat of direct government interference in drug pricing would likely abate for a while. **AstraZeneca** received a further lift on news it has been upgraded to 'equal-weight' from 'underweight' at Lehman Brothers, with an increased price target of 2240p from 2130p previously. Lehman explained in a note to clients that its previous negative call on AstraZeneca was based on Crestor and Exanta concerns. It highlighted that since Exanta's failure with the FDA, the stock has fallen 15% and the broker feels the negatives have now been priced in. On balance, over the month AstraZeneca shares are unchanged at 2306p, but a bounce appears underway, with 2355p the next potential target. The **S252 SG AstraZeneca 2000 01/06/2005 call** warrants are trading at 47p. They offer leverage of 4.35 times for a premium of 7.11%. The delta is 0.89. We rate them a BUY.

After reporting a 5.4% increase in passenger traffic in September, with first half traffic rising 7.5%, the UK airports operator **BAA** has subsequently reported interim results that Panmure noted were "strong." French broker CAI Cheuvreux said the passenger figures, which were reported earlier in the month, were in line with expectations, but also noted the stock has been up with events recently. Dresdner reiterated its 'add' recommendation. BAA reported interim pretax profits of £363m against £312m a year earlier. Panmure said BAA's profit came in line with expectations, and highlighted that Terminal 5 remains on track. While Panmure retained its 'hold' rating and 580p target on BAA, the broker argued that this is fundamentally a very good company, with 13% EPS growth expected for this year and next. Meanwhile, HSBC said it is keeping its 'buy' rating on BAA post the results, with a 620p price target. BAA shares are up 3.59% to 576.5p, and are potentially headed for 586p and 590p if 560p remains support. The **S257 SG BAA 500 01/06/2005 call** warrants are up 13.86% to 106.15p. At this level they offer leverage of 5 times for a premium of 5.14%. BUY.

Shares in **BAE Systems** have been lifted 5.45% to 232p by bullish comment from Deutsche Bank and Lehman Brothers. In a note to clients, Deutsche Bank reiterated its 'buy' recommendation and raised its target to 300p from 250p, arguing that the risks at the group's Programmes unit are falling more quickly than expected, while it feels the imminent agreement of a new Eurofighter contract should see risks reduce further. Overall, the German broker said it believes that its prior valuation assumption, which had placed a negative value on Programmes, now looks excessively conservative. Lehman Brothers meanwhile, repeated its 'overweight' recommendation, noting that given recent solid results and the absence of mishaps, investors are now asking how good BAE might be. The broker noted that having analysed the group on the basis of 2005 and 2006 EBITDA multiples, discounted cash flows (DCF) and the market value of its Saab shares, it has calculated a mean sum of the parts valuation of 337p and therefore remains comfortable with its 285p target. The chart suggests that as long as 230p provides support, the shares could be headed towards resistance around 250p, and beyond to 270p. The shares could be about to test 230p, but if the level holds, we would recommend a switch into the **J075 JPMorgan BAE Systems 210 17/06/2005 call** warrants. At 26.5p they have leverage of 6.36 times for a premium of just 1.94%. BUY on a bounce from 230p.

Goldman Sachs has been prompted by sky-high high oil prices to cut its forecasts for a number of European airlines, including **British Airways**. "There is no mystery behind our thumping industry downgrades; oil remains stubbornly high, meaning 2005 is likely to be another loss year," the broker said, pointing out that its 2005 EBIT estimates for sector players fall between 25% and 64%. "The recent share price strength cannot be reconciled with the still high oil forward curve," it said. "If the curve is right, the sector could nose-dive again." However, British Airways remains an 'outperform', as it "should fare better," it said. Meanwhile, Morgan Stanley re-started coverage of the airline sector with a 'cautious' view, and following a disappointing September traffic report from British Airways, said its least favourite stock is the UK flag carrier, which it rated 'equal-weight'. Morgan Stanley said that with oil above US\$50 per barrel, a widely anticipated particularly difficult winter trading period and the lingering influence of governments within the industry through the remainder of 2004 and into early 2005, investors are best served staying out of the industry until there are 'clearer skies' on both the competitive and macro-economic fronts.

Although overall September passenger traffic was up 3.6% compared with last year, BA's mix was unfavourable with premium traffic down 0.2% and non-premium up 4.2%. BA's statement that market conditions still have not changed also upset the bulls. "Longhaul premium volumes are recovering, while shorthaul premium travel remains at lower levels. Non-premium volumes are very price-sensitive," said BA, reiterating guidance for a year to end-March 2005 revenue increase of 2%-3%. HSBC immediately reiterated its 'reduce' recommendation and 180p price target. British Airways shares are, on balance, up 1.55% to 213p over the month, but it has been a very volatile period for the airline's shares, which have responded to changes in the oil price on a daily basis. The chart continues to suggest the shares are under pressure, and that the failure to break resistance at 223p could signal a retest of support at 196p and a fall towards 184.5p and 160p in extension. The **D042 DrKW British Airways 280 13/05/2005 put** warrants are trading at 71.07p. The warrants offer leverage of 2.14 times for a premium of 1.91%. These warrants offer the best technical value, we think, but the spread of 67.69p-74.45p unfortunately removes the gloss. The delta is 0.71.

Shares in **Man Group** have risen sharply after *The Guardian* newspaper reported speculation a major American financials firm has approached Man regarding a potential takeover of the group. Dealers said the name in the frame is Merrill Lynch, noting the same rumour had done the rounds last year. "The rumour on Man Group may hold some truth", said one dealer, as he highlighted the recent acquisitions of hedge funds by investment banks. Recently, JP Morgan Chase agreed to buy control of US\$7bn hedge-fund company Highbridge Capital Management. At the time, *The Wall Street Journal* reported that the purchase valued Highbridge at more than US\$1bn, making it one of the largest hedge-fund acquisitions ever. Lehman Brothers has been rumoured to be in talks to buy hedge-fund firm GLG Partners, in a deal that could be worth as much as US\$2bn. Despite the increased interest in hedge funds, some dealers remained sceptical about any deal with Man Group, arguing that the market is just beset with M&A rumours in the financial sector. Man Group shares have jumped 10.71% to 1334p, which in turn has propelled the **G691 Goldman Sachs Man Group 1500 18/03/2005 call** warrants 105.85% higher to 75.65p. Despite the sharp rise in the share price, the delta of the warrants remains only 0.19 as the shares remain significantly below the strike price. SELL.

**mmO2** shares have been lifted 10.82% to 107.5p by an upbeat assessment of its prospects from the company's management, a mix of analyst comment, the resurfacing of bid rumours, and the potential for higher dividends and a share buy-back. mmO2 raised its full-year revenue growth guidance for its core UK business. In a trading statement covering its fiscal first half, mmO2 said it now expects UK net service revenue growth of 9% to 12% in the 12 months to the end of March 2005, compared to its previous 7% to 10% growth forecast. This was due to "further growth" in its customer base and higher average revenue per user, particularly from contract customers, said mmO2. EBITDA margins in the UK business are expected to be stable for the full year, in line with previous guidance, said the group. Stockbroker Cheuvreux said it was raising its earnings per share forecasts for this year and next by 9% and 4% to reflect the raised revenue guidance in the UK. Reiterating its 'outperform' rating, the French broker cautioned that the statement might not allay some of investors' longer-term concerns over the company. Joint house broker Merrill Lynch also urged caution, echoing mmO2's warning of a "significant" slowdown in second-half service revenue growth. "The second half of the year will be a lot tougher for mmO2 [with] increasing levels of competition in the UK and termination cuts both in the UK and Germany," said Merrill, which repeated its 'neutral' rating. Williams de Broe analyst Morten Singleton had a similar take on the update. "The statement is positive but I remain negative on mmO2's prospects," he said. "The risks from increased competition are evident; Hutchison's 3, for example, is starting to gain traction." However, Cazenove, mmO2's other joint house broker, repeated its 'outperform' rating, although it warned that it was "a little more cautious than usual" due to "concerns over customer service and the launch of 3G services". Morgan Stanley published a positive note on the UK mobile phone group, reiterating its 'overweight' rating and 120p price target. Although Morgan Stanley said mmO2 was "no longer a top pick", it added there is still room for encouragement in November, and it is "too soon to switch out". It said it still likes mmO2's operating momentum, although the recent rally in the share price has brought its forecast upside on mmO2 down into line with the sector average. Furthermore, Morgan Stanley said it believes the group will post a dividend of 3p in full year 2006, along with a share buyback of £1bn. The broker added fears about bundles in Germany and SACs in the UK are "overdone." Dealers also highlighted renewed speculation that Spanish group Telefonica SA or KPN NV could be mulling a bid for mmO2. Regarding KPN, some dealers think the group needs to do something to survive while at the same time arguing a deal makes strategic sense for Telefonica. However, other dealers argued that Telefonica has maintained it is not interested in a UK mobile or mmO2, as the Spanish group's strategy remains focused in Spain and Latin America. The sharp rise in the shares has lifted the **G714 Goldman Sachs mmO2 100 17/12/2004 call** warrants 100.41% to 9.88p. The warrants are due to expire on 17<sup>th</sup> December, so holders may wish to consider selling out after such a sharp rise.

Shares in **Prudential** have slumped by 9.1% to 415p after surprising the market with a £1bn rights issue. In response, Panmure Gordon reiterated its 'hold' rating on the insurer, saying as there is no clear investment case alongside the fundraising, it would seem Prudential needs to sell its credit card unit Egg to finance growth. Meanwhile, Merrill Lynch reiterated its 'buy' rating but cautioned the rights issue would initially

be dilutive to earnings since the proceeds will be invested in fixed income bonds. But the broker added it would not have an impact on the dividend policy of the group. Referring to new business figures also announced, the US broker said the numbers were broadly in line, with all territories posting healthy growth. Lehman Brothers downgraded Prudential to 'equal-weight' from 'overweight' with a reduced price target of 453p from 555p. Lehman said in a note to clients that the downgrade reflects the impact of Prudential's capital raising and the view that this could contribute to future returns on embedded value being diluted to around 14% per annum from the broker's previous forecast of 16%-17% from 2005. Lehman also highlighted it does not believe that Prudential's capital raising is likely to result in a greater level of growth than the broker was already forecasting. Moreover, Lehman argued there is some lack of clarity over the drivers behind the quantity of capital raised and precisely how and when this capital will be deployed to fund future growth. Adding to this, Lehman also feels that this issue has negatively affected management credibility, especially given the recent disappointment over the failure to sell Egg. Lehman cut its new business margin expectations in the UK to 23.5% from 25% to reflect Prudential's disclosure on new business profitability for certain product lines and the US broker also reduced its valuation of Egg to 100p per share from 120p previously. Some see the fund raising as the final straw, and that chief executive Jonathan Bloomer's reputation amongst investors has been damaged, according to the *Financial Times*. Some investors had already lost faith in Bloomer after his failure to offload Prudential's 79% stake in internet bank Egg, the recent dividend cut, and the failure to merge its US business with American General. The sharp fall in the price has opened up 380p as a possible downside target for the shares. On this basis we would recommend the **S285 SG Prudential 450 01/06/2005 put** warrants. At 5.45p, the warrants have leverage of 5.16 times for a premium of 4.70%. The delta is 0.68. BUY.

Shares in **Vodafone Group** have been lifted on the back of generally upbeat comments from brokers following an investor day with the telephone company. Investec said the meeting with management renewed its confidence "in the fundamental health of the company, the industry and its expectation that the shares can perform strongly". The company's chief executive has reiterated gearing guidance and his intention to raise the proportion of cash paid out to shareholders, the broker added. As a result, Investec said it still expects a material rebasing of the dividend at the interims as well as a likely extension of the share buyback programme. It stuck to its 'buy' stance. Meanwhile, JP Morgan said Vodafone shed more light on its cost cutting programme, with pretax cash flow synergies of £2.5bn per year by 2008 unveiled, as it reiterated 'overweight'. JP Morgan has also added Vodafone to its European Model Portfolio, replacing BG Group. The meeting also prompted ABN Amro to raise its price target for Vodafone shares to 155p from 140p. In a note to clients on the wireless telecom services sector, ABN Amro argued the dynamics of the industry "are changing in ways not yet priced in by the market". It said it forecasts long-term capex to be lower than expected and shareholder value higher. Vodafone has been reaffirmed at 'add'. The broker has an 'overweight' view on wireless telecom services industry. Vodafone shares are up 8.17% to 142.25p over the month, and the chart suggests further upside is possible. As long as support at 137p holds, the immediate upside should be maintained. The **G688 Goldman Sachs Vodafone 110 18/03/2005 call** warrants are up 39.03% to 33.13p. They now offer leverage of 4.16 times for a premium of 0.62%. BUY.

## OTHER COVERED WARRANTS

After floating at US\$85 in August, **Google** shares are now testing the US\$200 level. The shares have more than doubled since their flotation on 18<sup>th</sup> August, and have risen by an amazing 60.45% to US\$196.25 since the October newsletter, lifted by demand from institutions who sat out the initial IPO tender offer due to what appears to be a bout of sour grapes. Google's love-hate relationship with Wall Street led to many investment bankers making it clear they would not get involved in the initial IPO, which Google was forced to slash to just US\$85 per share from an initial IPO range of between US\$108 and US\$135. The bankers did not particularly like the tender system, or the fact Google conducted itself to the letter of the regulations and did not provide any information about the company that was not contained within its prospectus. During the tech boom of 2000, investment bankers were often provided with privileged information and access to new issues, and when Google did not play along, noses were put out of joint. They have since been scrambling to pick up stock in the market, which in turn has driven the shares to their current level, just short of US\$200. Of course, this could mean a sharp correction is on the cards for the shares, and for this reason we would recommend SELLING the **G736 Goldman Sachs Google 105 17/12/2004 call** warrants, which are up 263.07% to 513.20p and the **G734 Goldman Sachs Google 110 18/03/2005 call** warrants which are up 240.80% at 510p.

In Japan, the **Nikkei 225 Index** has been comparatively dull for a while, failing to pick up on the late summer rally which some other markets enjoyed. Indeed over the year to date the index has barely moved on balance – it began the year at 10,676 and currently stands at 10,887. Over six months the Nikkei has underperformed by 10% against the FTSE 100 Index and by 5% against the Dow Jones Index. There is nothing new in that, of course, but with the prospects for real economic recovery in Japan seeming so much more certain now, we wonder whether there

might be scope for Japanese stocks to outperform from this base. The main factors which have held the market back may not be such hurdles for the market from this point onwards. First, the high and rising oil price has been a big worry for the Japanese market. Reports say concerns that high energy costs would eat into corporate profits and deter consumer spending had been one of the main factors behind the Nikkei average's recent decline. Oil prices are more stable now around the US\$50 mark, which leads us to believe that this concern may diminish unless crude starts to move higher again. Second, the market has been fretting over the outcome of the US election, which has now taken place. Looking at the chart of the Nikkei, it does seem to us that a base has been formed around 10,500. The index has formed a triangle pattern with this as the base, off which it has now bounced several times. For as long as this base holds, we can foresee a decent chance of a bull run from here. SG, Goldman Sachs, and Dresdner Kleinwort Wasserstein all have calls available on the Nikkei 225 Index. Most were, unfortunately, issued at higher levels and are speculative now as a result. The only ones which strike us as worth considering are the **S613 SG Nikkei 225 11,000 11/03/05 calls**, which at 28.025p offer leverage of 11.62 times for a premium of 4.83% and a CFP of 15.25%. Be warned though that they are currently out-of-the-money, so if the Nikkei fails to rise then they will expire worthless.

---

## NEW CORPORATE WARRANT ISSUES

---

### Finsbury Worldwide Pharmaceutical Trust plc

Investment trust warrants are becoming thin on the ground these days, so it is a rare pleasure to be able to report on a new issue from the sector. Finsbury Worldwide is a £180m existing trust which is planning a secondary issue to raise more than £40m. This money will fund new investments, improve liquidity, and will also cut the costs per share for the trust's shareholders. As part of the proposals it is intended that warrants to subscribe for ordinary shares will be issued as a bonus on the basis of one warrant for every five existing and new ordinary shares. The trust has indicated that placing commitments are being sought by mid-November, with completion in early December, but will make another announcement in due course.

Finsbury Worldwide Pharmaceutical Trust invests worldwide in pharmaceutical and biotechnology companies with the aim of achieving a high level of capital growth. It generally aims to have around 35 core holdings. Top holdings include Genentech, Genzyme, Novartis, Pfizer, Amgen, Schering-Plough, and Eli Lilly. You may well have heard of some of these major companies, at the same time noting the absence of major UK stocks such as AstraZeneca and GlaxoSmithKline. The trust's manager Samuel Isaly says "of the large pharmaceutical companies we believe GlaxoSmithKline and AstraZeneca have relatively poor outlooks so we have positions in Novartis, Lilly, and Takeda instead." Samuel Isaly is based in New York, with Orbimed Advisers LLC, who have been the advisers to the trust since September 1998. Close Finsbury has a policy of engaging boutique specialist managers to look after its funds. Orbimed are focused investors who invest solely in the global healthcare sector, with over US\$5bn of assets under management. Their coverage extends from private equity to quoted biotechnology, and through to the pharmaceutical giants mentioned above. The team has 16 investment professionals, headed by Samuel Isaly. Not surprisingly perhaps, the trust has a considerable geographic bias towards North America, where around 71% of assets are invested. Europe accounts for 19%, and the Far East for 10%. The high US exposure is especially relevant at this time because of the US election, which the managers believe has depressed the prices of many healthcare stocks. Certainly, short-term performance has been nothing to crow about, unlike the trust's longer-term record, which is very good. Over five years the trust beats all-comers in the technology and life sciences sector with a total return of almost 100%. We understand the new warrants will have a five year life, with an exercise price set approximately 5% above the trust's net asset value. On the subject of the net asset value, it is worth noting too that the trust is introducing a discount control mechanism, as is becoming increasingly common. Returning to the warrants, our back-of-the-envelope calculations suggest a price of around 135p, implying value of 27p per share for any investors buying the shares now. This looks like a good deal, effectively drawing the shares back down from a premium of 2.3% - achieved on the back of these proposals - to a discount of 3.9%. The average discount for the shares over the last twelve months is 3.1%. There may just be some benefit, then, in buying the shares now to get the free warrants, although following a sharp rally in the share price over the last few days this decision looks fairly marginal now. It may be better just to wait until the warrants are issued, and to assess their value at that point. Doubtless we will be reporting on this trust again.

### SubSea Resources plc

Here's an odd company to sink your money into, even by the standards of AIM, which embraces a diverse range of companies. SubSea is a UK-based company which aims to recover high value non-ferrous metals and other valuable cargoes from deep water shipwrecks. The company

explains that only a handful of wrecks have been salvaged in water depths exceeding 1000 metres, whereas hundreds have been worked on in depths down to 300 metres. The barrier to deeper work has been a lack of technology, which is now available mainly due to developments in the offshore oil and gas industry. SubSea Resources has identified at least 70 commercial salvage targets and has identified twenty major target vessels containing cargoes with a gross value of over US\$450m (based on recent LME metal prices and contemporary lading records). In the first phase of the company's business plan it aims to raise the cargoes from six of these vessels over the next three years. In addition, it is anticipated that certain historic cargoes may be integrated with the commercial salvage operations. Some of the historic targets have potential values of many millions of dollars each, bringing the combined value of identified historic and commercial targets to well over US\$1bn.

SubSea aims to raise £10.4m before expenses from its AIM flotation, and to press on with its work. The first commercial salvage target has already been located and the contract with underwriters agreed, allowing salvage of its cargo to begin in Spring/Summer 2005. A further five commercial salvage projects are planned, the total estimated gross cargo value of the initial programme (to 31st March 2008) is approximately US\$180m. Mark Gleave, managing director said "this transaction represents a unique opportunity to invest in the marine salvage industry. SubSea Resources plc will be the only company in the industry to combine years of research and testing with a financial structure adequate to conduct salvage operations on a commercial scale." The company is listing 107m ordinary shares at 20p each, and 26,761,568 warrants, attached on a 1-for-4 basis. Trading is due to start just as this newsletter is at the printers, on 4<sup>th</sup> November. Each warrant carries the right to subscribe for one ordinary share at a price of 40p, exercisable at any time up to or on the date which is five years from the date of admission. The warrants will only come into their own, then, if the company does very well and generates real value for shareholders. Working on the issue price of 20p for the shares, we think the warrants might realistically fetch around 2p-2.5p, although it is tricky placing a value on warrants which will necessarily carry a high premium.

## **ADDleisure plc**

ADDleisure has floated on the AIM, with 100m shares priced at 5p each, and 35m warrants with rights to subscribe for shares at the same price. The company plans to invest in health, leisure and fitness opportunities. It raised £1.5m from the issue of new shares, and was capitalised at £5m at the flotation price. Some of the new money was raised from an offer for subscription to shareholders and warrant holders of Westside Acquisitions – these 3m shares were fully subscribed, and another 27m shares were placed with institutional and other investors.

The company believes that the growing concern over health and fitness issues such as obesity and heart disease by both the government and the public will create more pressure on people to take regular exercise. The dramatic increased awareness of the importance of physical health and the need to find solutions has resulted in an opportunity to develop and promote new highly differentiated leisure offerings to the leisure industry as a whole, as well as market fitness products and services to the millions of people who want to remain healthy but do not belong to gyms (for whom fitness clubs are not an option either because of geography or choice). ADDleisure, whose directors have extensive experience in the sector and have already invested £500,000 in the company, hopes to capitalise on a variety of leisure opportunities and has already made two initial investments. Through these, it is rolling out two key products aimed at people who want to fight ill health, stress and obesity or who simply want to achieve a healthier lifestyle. The company has a 75% stake in Fitbug Limited, which has developed what it calls "a unique lifestyle health and fitness product" that uses technology and internet connectivity to regularly measure, motivate, manage and prescribe physical activity and dietary requirements for its users. ADDleisure also owns 28% of Liberation Fitness Systems, which markets and distributes the 'Power Plate' range of products in the UK and Ireland, these being "innovative fitness products that use vibration technology to stimulate muscular and circulatory responses." Originally developed to train elite athletes, the company says, this technology "is now recognised to have benefits for physical therapy, stress relief, anti-aging, sports rehabilitation, beauty/spa conditioning including cellulite reduction, alternative medicine and fighting osteoporosis." The Power Plate was introduced in the Netherlands in 1999. Today it is licensed for distribution in over twenty-four countries including Italy, Spain, France, Japan, China, South Korea, Canada and the USA and is widely used by professional sports teams, training centres, rehabilitation /medical facilities, gyms and private home users.

ADDleisure Chairman Allan Fisher said "since 1998 the in-home fitness equipment market has grown by almost 50% and is currently worth £250m. Forecasts suggest it will continue to show double-digit growth rates. We believe that our experienced team can take advantage of this growth by initially further developing and marketing our existing products, and latterly, sourcing future investment opportunities." The company has a highly experienced management team, including Allan Fisher, the chairman, who founded Holmes Place plc, of which he was chief executive when it floated in 1997. David Turner, the chief executive, was a founder member of LA Fitness plc, which floated in 1999.

The shares are now 6.75p, and the warrants are trading at a penny (dealing spread 0.5p-1.5p). Each warrant is exercisable at 5p for one ordinary share at any time until 19<sup>th</sup> July 2009. You may well be struck immediately by an anomaly here. Yes, the warrants are on a discount of 11.11%, based on these mid-prices. The discount disappears if you buy the warrants at 1.5p, exercise at 5p (making a total of 6.5p) and then sell the shares at their bid price of 6p, but we still think this rating is too cheap. Our calculations suggest that a mid-price for the warrants of 3p would not be stretching the valuation too far, implying gearing of 2.3 times for a CFP of 6.30%. Unfortunately the liquidity of the warrants is not very good. Their market capitalisation is only £350,000, and 57% of the warrants are held by the directors, the brokers, and by Westside's Reverse Take-Over Investments subsidiary. The free float is small, and the screen dealing size is only 10,000 warrants (£150 at the bid price). You may be able to deal in more, but realistically you will be limited to a fairly small sum. Subject to this caveat, we rate the warrants a clear BUY.

## CORPORATE WARRANTS NEWS

On 1<sup>st</sup> November, **Cheerful Scout**, the AIM listed multi-media group, held its AGM. Chairman Stuart Appleton said that "the company is making significant progress with trading up in the first three months compared to the previous year's corresponding period." He continued "Cheerful is focused on building its existing offering while also expanding into additional market areas with new products. In line with this, we have launched a new presentation software package which provides the seamless and high speed integration of several live event elements." Cheerful Scout shares and warrants have lived up to their name for once and responded well to this news, jumping in response from their previously depressed levels. The shares are up by 277.8% and the warrants by 114.3% to 0.225p. At this level the gearing is 7.6 times for a CFP of 23.60%.

There have been more developments at **Deutsche Latin American**, where the trust's board has stalled over its controversial reconstruction plans. On 6<sup>th</sup> October the trust said that it has been consulting with shareholders, and that "it is clear from these consultations that shareholders will support proposals for the continuation of the company, albeit with a different investment remit, particularly if this produces improved marketability for the company's shares and is an improvement upon a voluntary liquidation of the company." The board believes that specific proposals put forward by Aberdeen Asset Management may achieve this objective. Accordingly, the Board has agreed that Aberdeen Asset Management should have a limited amount of time to develop its proposals to a state where they are capable of implementation. A further announcement will be made in due course and, if the proposals are capable of implementation, it is expected that the future of the trust will be finalised before the end of the year. If the proposals do not achieve the conditions set, then the trust will proceed with a voluntary liquidation which it would also expect to complete before the end of the year. The trust has until February 2005 to put proposals to shareholders but would prefer to resolve matters as soon as is reasonably practicable. In the meantime, the portfolio continues to be managed in accordance with its existing remit. Deutsche Latin American shares are up by 5.3% to 84.75p, and the warrants are clearly factoring a success for the Aberdeen approach, up by 16.7% to 12.25p. We hope this expectation is met, otherwise the warrant price will probably fall back to earth with a thud.

**York Pharma** has followed through on the momentum which carried the shares so much higher in September. Over the last month they have advanced by a further 10p to 100p, pushing the warrants up by 2.9% to 53.5p. Technically, the warrants look attractive at this level, with 50p of intrinsic value and a small premium of 3.5%. Gearing is 1.9 times for a CFP of 1.71%. In spite of this unstretched rating, however, we have our doubts whether this share price can be sustained. The shares shot higher on a bullish note from the company's brokers, and the level of expectations is such now that investors could easily be disappointed. We would be inclined to exercise caution unless and until York Pharma produces some concrete news on which to base its much higher valuation.

**Your next newsletter is published on Saturday 4th December.**

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. Published by The McHattie Group, Clifton Heights, Triangle West, Bristol, BS8 1EJ. © 2004. Tel: 0117 925 8882. Fax: 0117 925 4441. 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.