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More options than you thought

Buying listed call options over new shares is an alternative entry to over 120 ASX-listed early-stage resources companies.

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Good call: Call options offer opportunities for both profits and losses

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Toward the exploration end of the development chain, investors usually have clear timeframes in mind within which specific price-sensitive events are expected to occur. Call options are a good match for how returns are generated among these early-stage mining stocks.

Market inefficiencies can make options a relatively cheap way to gain additional leverage while limiting the potential for capital loss.

Against their usefulness as a near-term trading tool, the decay in time value makes them less well suited and a possibly inappropriate tool for investment commitments extending over a normal development horizon. Loss of time value can be managed more easily in positioning shorter-term trades.

For companies, call options play a dual role. They can be used to entice new investors as well as act as a capital-raising tool.

Attaching a so-called free option to a share issue can mitigate the need for a deeper discount on the shares without impacting cash flows adversely.

In September, base metal explorer Thundelarra issued one option with 24 months to expiration for every two shares purchased in a renounceable rights issue. The option strike price was double the depressed price at which the shares were being issued but well within the trading range of shares over the prior year.

Impact Minerals issued one option for every share taken up in an institutional placement at the start of November. The option, timed to expire in June 2020, helped massage a share issue at a premium to the market.

> **Company issued options, like those of St George, create a wider range of opportunities for qualified investors looking for alternative ways to manage their market exposures**

Underpinned by high-quality exploration programmes, the prices of both company's options have since doubled.

Cyclically weak macro conditions have hampered use of options to source fresh capital, on the other hand. With sinking share prices leaving options to expire out of the money, companies have frequently lost the anticipated funding benefit.

As previous tranches of options have expired, some companies have been able to re-price their capital market exposures.

St George Mining had its hopes of raising up to A$9.5 million (US$7.2 million) from its June 2017 options dashed despite its own increasingly successful nickel exploration efforts.

In August, the company simply initiated a 1:10 bonus issue of new options with three years to expiry. In the two days immediately before the record date for the issue, stock turnover was 10 times higher than the daily average over the prior three months and the share price rose by as much as 51%.

The average time to expiry of all mining company options currently listed on ASX is 18 months. Share prices closed on November 17 at a median discount of 43% to the exercise price of the related options.

Using the standard Black Scholes methodology, the median valuation discount to the offered price of the options was just 5%, close to theoretical perfection.

The narrowness of the difference does not signify a highly efficient market or tight limits on trading opportunities. The variations around ‘fair value' of the individual securities are enormous with a standard deviation of 124%.

The liquidity in options trading also varies considerably. Throughout last week, there were no offers of Havilah Resources options, for example. Since its renounceable rights issue closed on October 31, only one small trade had occurred at a price 40% below the Black Scholes valuation.

In contrast, St George Mining options have traded on all but four trading days since early October. Even so, St George option turnover remains relatively low with volumes running at just 6% of the turnover in ordinary shares.

Overall, 18% of listed options lacked either a bid or offer at the close of business last week and the median bid-offer spread on the remainder was 10%.

In some instances, market movements even among companies with strong mineral endowments have given options extraordinary leverage to improved share prices. Parkway Minerals - a phosphate and potash mine developer - has options with a year before expiry. Their strike price is now nearly six times higher than the latest share price. A return to June 2016 prices implies a 70-fold rise in the option value.

Potential leverage to share price improvements varies considerably. A currently open offer from Aspire Mining, a Mongolian coking coal mine developer, implies a 29% gap between the current market price of the ordinary shares and the exercise price of the newly-issued options.

A doubling of the Aspire Mining share price would do little more than double the option's theoretical value. Over time, the choice will increasingly favour the ordinary shares.

St George, which has some of Australia's most exciting exploration assets, is an unfolding example of the potential trading opportunities.

St George options were modestly undervalued at the end of last week by 21%, according to the option model. As it happens, St George announced prior to the market opening on Monday that drilling at its Mt Alexander property in Western Australia had intersected 5.5% nickel and 2.1% copper.

As this column is being finalised, the St George share price has made a net gain of 73% over the three days since Friday while the options, now in the money, have added 92%.

The St George options are still trailing 26% behind the recalibrated model valuation and, with nearly three years to run, continue offering relatively cheap exposure to future drilling successes.

Company issued options, like those of St George, create a wider range of opportunities for qualified investors looking for alternative ways to manage their market exposures.

The market as a whole would also benefit from more widespread recognition of options as a trading tool as they could add important systemic liquidity.

Options are a worthwhile addition to the traders' toolbox although, in the interests of balance, it should also be pointed out that they might simply be another way to lose money.

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