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FEATURE ARTICLES

Warrant Pricing—Is Dilution a Delusion?

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Abstract

The textbook treatment of warrants takes as a state variable the total equity value of the firm and makes explicit allowance for the effects of equity “dilution” when warrants are exercised. Warrant pricing, however, could just as well be based on the process the stock price follows. This approach leads to a much simpler pricing model into which dilution does not enter, and in fact, a warrant has a value identical to that of the corresponding option. Moreover, valuations based on stock prices are fully consistent with those obtained using the standard equity value approach. In fact, when the comparison is made in a consistent fashion, the warrant prices obtained using the stock price method are identical to the results arising from the textbook method.

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