Preferred Shares

An Introduction

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"Preferred Share" is a class of equity that ranks senior to common equity. Preferred shares are often described as a "hybrid" security because they have both bond-like and equity-like characteristics.

Preferred shares are an important source of capital for Canadian corporations and financial institutions, and are popular among income-oriented investors. In particular, investors are attracted to the relatively high and tax-efficient dividends that preferred shares pay. In this publication, we take a closer look at the features and characteristics of the different types of Canadian preferred shares.

Credit Ratings

As payment on preferred shares is not a legal obligation, they are generally viewed as higher risk investments than high-grade bonds and guaranteed investment certificates (GICs). Consequently, it is important to consider an issuer's financial strength before making an investment decision. Investors typically rely on the analysis of two Canadian credit rating agencies for this type of information. Dominion Bond Rating Service (DBRS) and Standard and Poor's Rating Service (S&P) rank issuers' creditworthiness with a rating system of "P-1" (highest) to "P-5" (lowest). Definitions of these ratings are provided in Figure 1. A "high" or "low" designation is also used to denote relative strength within each rating category. For example, an issuer with a P-2High credit rating is considered to be safer than one that is rated P-2 or P-2Low.

Preferred shares that are rated P-1 or P-2 are considered to be among the strongest entities. Companies with relatively stable operations and revenue are typically granted such high ratings. Shares in this category are usually recommended for conservative income-oriented investors. A P-3High or P-3 rating is acceptable, but is generally reserved for businesses that carry more debt, or that are sensitive to changes in economic conditions. Generally speaking, preferred shares that fall into the P-3 category are not recommended for conservative investors. Issues that are rated P-4 or lower are speculative and not recommended for investors who rely on the income from their investments.

Figure 1: Credit Rating Definitions

Category	Definition
P-1	Preferred Shares in this category are of superior credit quality, supported by strong earnings and balance sheet characteristics. P-1 ratings generally correspond with companies whose senior bonds are rated AAA or AA.
P-2	Preferred shares in this category are of satisfactory credit quality. Protection of dividends and principal is still substantial, but earnings, the balance sheet and coverage ratios are not as strong as P-1 rated companies. Generally, P-2 ratings correspond with companies whose senior bonds are rated A.
P-3	Preferred shares in this category are of adequate credit quality. While protection of dividends and principal is still considered acceptable, the issuing entity is more susceptible to adverse changes in financial and economic conditions. P-3 ratings normally correspond with companies whose senior bonds are rated in the BBB category.
P-4	Preferred shares in this category are speculative. The degree of protection afforded to dividends and principal is uncertain, particularly during periods of economic adversity. Companies whose preferred shares are rated P-4 will have a bond rating in the BB category.
P-5	Preferred shares in this category are highly speculative. The ability of the entity to maintain timely dividend and principal payments in the future is highly uncertain. The P-5 rating typically coincides with companies with bond ratings of B or lower. Preferred shares rated P-5 often have characteristics that, if not remedied, may lead to default.
D	This category indicates the shares are in arrears on paying either dividends or principal.

Member-Canadian Investor Protection Fund. Member of the Investment Industry Regulatory Organization of Canada. All figures in C$ unless otherwise noted

Preferred Share Dividends

Preferred shares are usually issued with a $25.00 par value. The annual dividend (or "coupon") is expressed as a percent of par value (such as 4.50%) or a dollar amount (such as $1.13 per share). Dividends are usually paid quarterly.

Preferred share dividends are paid out after interest payments are made to debenture holders and other creditors, and before dividends are paid to common shareholders. If a company were in financial distress, it would have to eliminate its common dividend before it would be allowed to reduce or suspend preferred share dividends.

Technically, preferred share dividends are described as either "cumulative" or "non-cumulative." Cumulative dividends, if suspended, would accumulate and would have to be paid in full before common dividends could be reinstated. Non-cumulative dividends, if suspended, would not accumulate. Notwithstanding these technical descriptions, a financially healthy company will always pay dividends on schedule.

Dividend Tax Credit

Canadian issuers pay preferred share dividends out of after-tax earnings. Consequently, by the time shareholders receive their dividends, the funds have already been subject to tax. To alleviate double taxation, individual investors are entitled to a dividend tax credit. The effect of the tax credit is that the tax rate on eligible dividends is significantly lower than it is for interest income. In Figure 2 we highlight the 2014 combined top marginal tax rates for individuals.

The "multiplier" equates interest income to eligible dividend income. For example, an investor in Alberta would have to earn approximately $1.3231 of interest to be as well off after taxes as they would be earning $1.00 of eligible dividends.

Figure 2: 2014 Combined Top Marginal Tax Rates by Province

Province	Eligible Dividends	Interest & Income	Multiplier
Alberta	19.29%	39.00%	1.3231
B.C.	28.68%	45.80%	1.3159
Manitoba	32.26%	46.40%	1.2638
New Brunswick	27.35%	46.84%	1.3666
Newfoundland and Labrador	30.19%	42.30%	1.2099
Nova Scotia	36.06%	50.00%	1.2788
Ontario	33.82%	49.53%	1.3113
Prince Edward Island	28.70%	47.37%	1.3547
Quebec	35.22%	49.97%	1.2948
Saskatchewan	24.81%	44.00%	1.3427

Note: The information in this Figure should be used for illustration purposes and should not be relied on for tax purposes.
Source: BMO Nesbitt Burns Enterprise Wealth Planning Group as of July 2014.

Redemption Feature

"Redemption" is the issuer's privilege to buy back its shares at par value (or a small premium) on specified dates, usually beginning five years after inception. Unlike a debt security, redemption of a preferred share is not mandatory.

Since all preferred shares are subject to redemption at some point, an investor should consider the "yield-to-redemption" prior to making an investment decision. The yield-to-redemption calculation factors in the dividends received, plus any gain or loss generated between the purchase date and the redemption date. If there is more than one redemption date, an investor should consider the lowest possible yield, which is known as the "yield-to-worst."

Since redemption of a preferred share by the issuer is not mandatory, a yield-to-redemption calculation is somewhat hypothetical. An issuer's decision to redeem a specific preferred share issue will depend on its re-financing options, credit market conditions and investor demand. Preferred shares that are expected to be redeemed within a relatively short period of time will trade close to their par value.

Types of Preferred Shares

The following is a brief description of the four main types of Canadian preferred shares: **Rate-Reset, Straight, Floating-Rate and Retractable.**

Rate-Reset Preferred Shares

At 61% of the total universe, the "reset" sector has become the largest segment of the preferred share market in Canada. In this publication, we focus on a type of reset preferred share that became popular during the Credit Crisis, which is known as "Rate-Reset".

Rate-Reset preferred shares pay a quarterly dividend that is fixed for a specified period, usually five to six years. At inception, the coupon is set at a rate that reflects the five-year Government of Canada bond yield at the time plus a specified credit spread.[1] The spread is fixed for the life of the investment, and is called the "reset spread".

Every five years, there is a "reset date". At that time, the shares will either be called for redemption at $25.00 or the coupon will automatically reset at the prevailing five-year Government of Canada bond yield plus the reset spread. If an issue is not redeemed, holders have an opportunity to exchange their shares for a corresponding floating-rate series, as described in the following paragraph.

Example:

ABC Corporation issued a rate-reset preferred share on September 31, 2014. The coupon rate was initially set at 4.00% ($1.00 per annum), which equated to the five-year Government of Canada bond yield at the time (1.60%) plus a spread of 2.40%. The initial 4.00% coupon is fixed until the first rest date of September 31, 2019. At that time, if the shares are not called for redemption, the coupon will automatically reset to the five-year Government of Canada bond yield plus 2.40%.

Let's assume that the five-year Government of Canada bond yield is 2.10% on the first reset date. The new coupon rate would be 4.50% (= 2.10% + 2.40%) and the dividend would be $1.13 for the next five years. If the five-year Government of Canada bond yield was 3.00% on the first reset date, the new coupon rate would be 5.40% (= 3.00% + 2.40%) and the dividend would be $1.35 per annum for the next five years.

Holders of ABC's rate-reset shares will have the opportunity to exchange their existing shares for a corresponding floating-rate series whose dividend is based on the 90-day Canada T-bill yield plus the same reset spread.[2] For example, if the 90-day Canada T-bill yield was 1.00% on the first reset date, the first quarterly dividend would equate to 1/4 of 3.40% (= 1.00% + 2.40%). A shareholder would opt to exchange for the floating-rate shares if short-term interest rates were forecast to rise significantly, or if they simply wanted some floating-rate exposure.

Reset Risk

Rate-Reset preferred shares are redeemable at the issuer's option every five years on the reset date at $25.00. The decision to redeem an issue or leave it outstanding will depend on the issuer's financing options, credit market conditions and investor demand. Specifically, if an issuer could raise funds at a lower cost (i.e., a lower credit spread), they would probably redeem the existing shares and refinance. If refinancing was not in the issuer's best interest, they would likely allow the existing shares to reset at the fixed reset spread.

The ability for an issuer to allow these preferred shares to reset adds an element of risk, which we call "reset risk". If an issue is allowed to reset, it's likely that its reset spread is considered low in the context of the market at the time. If an issue's reset spread is low, its market price will likely fall below par value.

[1] A credit spread is the yield differential on a corporate debt security or preferred share over the Government of Canada bond yield.
[2] All rate-reset issues have the floating-rate option except for Fortis Series G (FTS.pr.G).

Straight Preferred Shares

Straight preferred shares pay a fixed quarterly dividend, and are redeemable at the issuer's option, as described on page 2. As redemption is not mandatory, straight preferred shares are considered to have a very long term and are commonly known as "perpetual". Because longer-term fixed-coupon securities tend to be highly sensitive to changes in interest rates, investors who buy straight preferred shares must be prepared for relatively high price variability when market yields rise or fall.

Straight preferred shares usually offer a high current yield[3] to compensate investors for the predictable volatility risk. Straight preferred shares are not widely popular among individual investors, but issuers like the structure because they (a) can lock in a fixed rate for a long period, and (b) don't have to buy the shares back at any particular time. Companies with a relatively stable business profile, such as banks, insurance companies, utilities and pipelines have been dominant in the sector for many years. The issuance of straight preferred shares has declined markedly since 2008, as investors have gravitated to the more popular rate-reset structure. Today, straight preferred shares make up approximately 31% of the Canadian preferred share universe.

Floating-Rate Preferred Shares

Floating-Rate preferred shares pay a dividend that floats with prime rate or Canada T-bill yields. Because its dividend is linked to market interest rates, a floating-rate preferred share will appreciate when rates are rising (or anticipated to rise), and decline during periods of falling rates, all else equal. The floating-rate sector is a small and relatively illiquid component of the Canadian preferred share market, representing only 4% of the Canadian preferred share universe today.

Retractable Preferred Shares

Retractable preferred shares pay a fixed quarterly dividend. The holder of a retractable preferred share has the right to return their shares to the issuer on a specified date (or dates) in exchange for par value. Retraction proceeds are usually paid in cash, but certain issues allow repayment with the issuer's common shares. The first retraction date is usually fixed at 5 to 10 years after inception.

The benefit of a retraction feature is that it tends to support the share's price as long as the issuer is financially sound. However, payment on a retraction date is not a legal obligation. As such, if an issuer was unable to meet a retraction deadline due to financial distress, the value of the shares would fall substantially and shareholders would likely suffer a significant loss. If that happened, the shareholders would have no legal recourse by which to claim their retraction proceeds.

In the past, retractable preferred shares were the most prevalent type of preferred share in the marketplace. However, companies prefer to issue shares that are not required to be bought back within a specified time period. Consequently, the issuance of retractable preferred shares has declined markedly in the past decade, and the structure only makes up 4% of the Canadian preferred share universe today.

Factors that Affect Preferred Share Prices

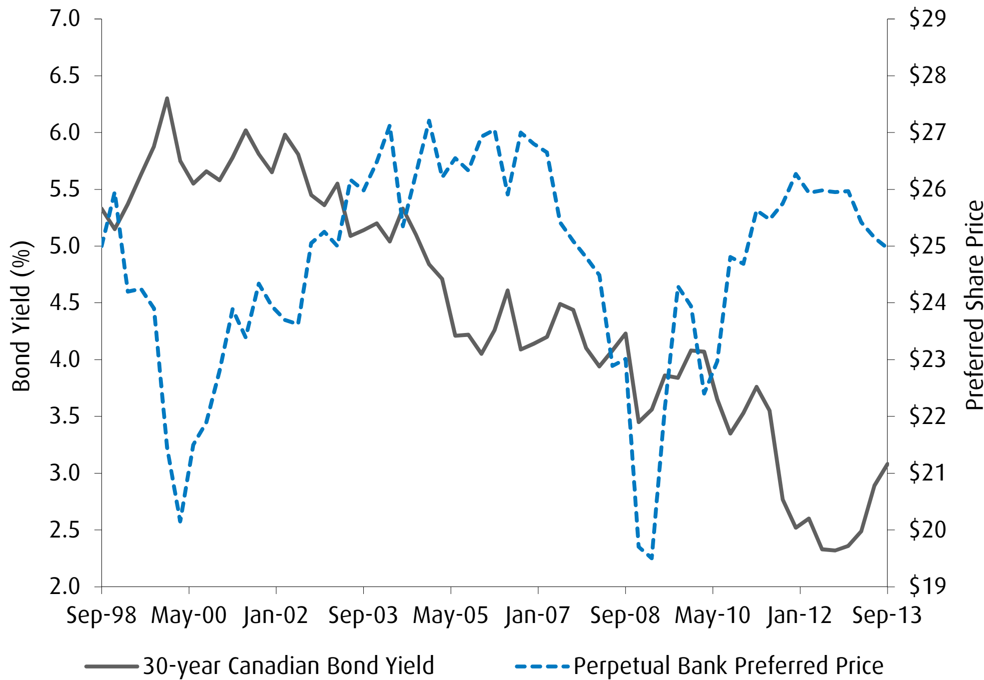
Several key factors that affect secondary market prices for preferred shares are: **interest rates, credit markets, issuer fundamentals** and **liquidity**, as described below.

Interest Rates

All fixed-rate securities are sensitive to interest rate movements to some degree, and preferred shares are no exception. Normally, we look for an inverse relationship between interest rates and preferred share prices, with longer-term issues experiencing the most volatility. Straight preferred shares, whose dividends are fixed for relatively long periods, are considered to be the most interest sensitive type of preferred share. Figure 3 highlights the price movement of a typical straight preferred share between mid-1998 and late-2013 when it was called for redemption at par value.

[3] The dividend divided by the market price.

Figure 3: Straight Perpetual Preferred Price vs. 30-Year Canada Bond Yield

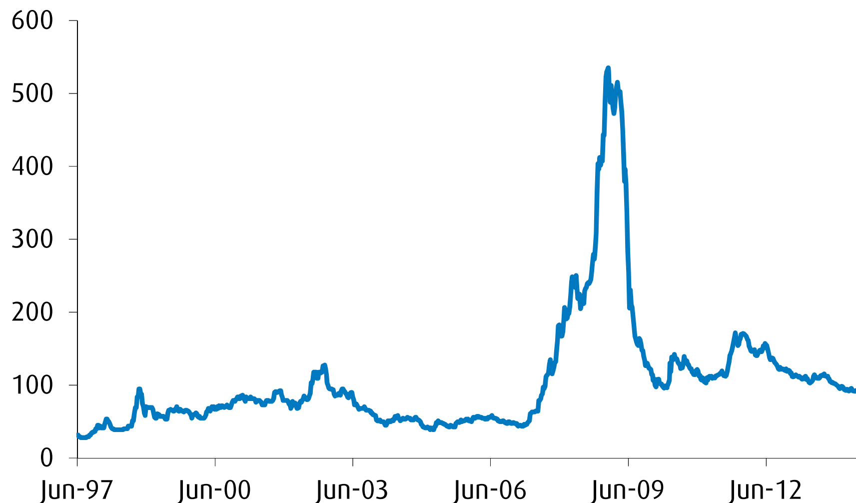


Source: BMO Nesbitt Burns. Data to September 2013

Credit Markets

Credit market conditions are reflected in the yield differential (the "credit spread") between Government of Canada bonds and corporate debentures and preferred shares. Typically, spreads will narrow during periods of economic prosperity and widen during periods of uncertainty. The most dramatic recent example of this was seen during the 2008 Credit Crisis when credit spreads spiked to unprecedented levels. The loss of confidence felt by investors during the crisis caused the prices of most preferred shares to plummet. Figure 4 highlights the variability in the spread on a generic single-A rated corporate debenture over the past 17 years.

Figure 4: Five-year A-Rated Canadian Corporate Indicative Credit Spread



Source: BMO Capital Markets

Issuer Fundamentals

Income-oriented investors are concerned about the safety of their capital and income, and prefer minimal price volatility. Consequently, they tend to seek out the highest quality issues in the marketplace and will pay more for them. If an issuer's fundamentals begin to deteriorate, the market price of its preferred shares will come under downward pressure along with its common shares.

Liquidity

The $61 billion market capitalization of the Canadian preferred share market is relatively small compared to approximately $400 billion for the Canadian domestic corporate bond market. Issue size typically ranges from $100 million to $400 million. Smaller issues with lower trading volumes tend to exhibit more price variability over time than large liquid issues.

Conclusion

Income-oriented investors are attracted to the quality, relatively high yield and tax efficiency that preferred shares offer. Liquidity in the preferred share market is limited however, and investors must consider the creditworthiness of the issuer prior to making an investment decision. Depending on their requirement for income and their risk tolerance, investors may find that placing preferred shares selectively in an income portfolio consisting of bonds, debentures, GICs and high dividend yield common equities can help enhance returns without adding undue risk.

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