BMO Nesbitt Burns®

Preferred Shares

— An Introduction

Investment Strategy Group
May 2006

Pat Keene
Elena Tzembelicos
Toronto, Ontario

Preferred shares are a popular income investment as they pay dividends on a quarterly basis. As preferred shares rank senior to common shares and junior to debentures, dividends are paid only after the claims of debenture holders are met, and before any dividends are paid to common shareholders.

A primary reason for issuing preferred shares is to help a company keep its debt-to-equity ratio in balance. This is important because issuing too much debt can jeopardize a company's financial condition and, in turn, its credit rating. Moreover, preferred shares offer the issuer financial flexibility because payments are not considered a legal obligation, as they are with debentures.

Credit Rating

As dividend payments are not a legal obligation, preferred shares are generally viewed as higher risk than high-grade debentures. As such, it is important to consider an issuer's financial health as part of the investment decision. Dominion Bond Rating Service (DBRS) and Standard and Poor's Rating Service (S&P) provide credit ratings for most Canadian preferred shares. These ratings, which range from 'P-1' (highest) to 'P-5' (lowest), are defined in Appendix A on page 5.

Issues that are rated 'P-1', 'P-2' or 'P-3' are considered to be financially sound. Financial institutions, pipelines and utilities are typically rated 'P-1' or 'P-2'. A 'P-3' rating is usually reserved for companies that are sensitive to economic cycles. A 'P-4' rating is an indication of financial weakness and/or high operating risk. All else equal, the weaker the credit rating, the higher the yield.

Dividends

Most preferred shares have a stated par value of $25. The annual dividend is expressed as a dollar amount (i.e., $1.30) or as a percent of par value (i.e., 5.20%). Dividends are usually paid quarterly. Preferred share dividends may be cumulative or non-cumulative. Cumulative dividends, if suspended due to financial distress, will accrue and must be paid in full before common dividends may be reinstated or before the preferred share may be redeemed.

Industrial companies and utilities usually pay cumulative dividends. Non-cumulative dividends do not accrue, so holders are not entitled to unpaid dividends if they are interrupted or suspended. Financial companies tend to pay non-cumulative dividends.

Dividend Tax Credit

Preferred share dividends paid by Canadian corporations are paid out of after-tax earnings. Consequently, by the time investors receive their dividend payment, it has already been subject to tax at the corporate level. To alleviate double taxation, individual investors receive tax relief through the dividend tax credit.

In late 2005, the Department of Finance proposed a change to the existing dividend tax credit that would reduce the Federal tax rate on dividends to 14.5% from 19.6%. The table below compares top Federal marginal tax rates for Canadian residents in the highest tax bracket assuming the proposed change is passed into legislation.

Top Federal Tax Payable on $1,000

	Capital Gains	Canadian Dividends	Interest
Distribution	$1,000.00	$1,000.00	$1,000.00
Inclusion Rate / Gross Up	$500.00	$450.00	0.00
Taxable Income	$500.00	1,450.00	1,000.00
Federal Tax (29% of taxable income)	145.00	420.50	290.00
Dividend Tax Credit	0.00	275.50	0.00
Total Federal Tax	$145.00	$145.00	$290.00
Top Federal Marginal Rate	**14.5%**	**14.5%**	**29.0%**

Redemption Privilege

Companies are permitted to buy back their shares according to a specific redemption schedule. Redemption is the issuer's privilege and is not mandatory. If interest rates fall substantially an issuer is more likely to redeem a preferred share in order to refinance at a lower rate. This is a disadvantage for shareholders who must reinvest the redemption proceeds in a lower interest rate environment. If rates rise substantially an issuer is unlikely to exercise their redemption privilege and the issue will remain outstanding.

Retraction Privilege

Some preferred shares are issued with a retraction feature that allows the shareholder to sell their shares back to the issuer according to a specific retraction schedule. If interest rates are relatively high on the retraction date, a shareholder is more likely to tender their shares and reinvest the proceeds in a higher-yielding investment. If rates are low, they will likely hold their shares for as long as possible.

Exchange Privilege

Certain issues allow a company to pay redemption or retraction proceeds with their common shares instead of cash. This is known as an exchange feature. If the issuer chooses to exercise this privilege, the number of new shares is determined using the formula illustrated in Appendix B on page 6. While it is rare for a company to exercise an exchange privilege, it adds an element of flexibility for the issuer if sufficient cash is not readily available.

Purchase Fund

Issues that contain a purchase or sinking fund are gradually repurchased and retired by the issuer according to specific terms. Under a purchase fund, the issuer agrees to retire a specified amount of shares each year by making purchases in the open market. Under a sinking fund, the company sets money aside every year to gradually retire the entire issue. If purchases cannot be made in the open market, the required number of shares will be called for redemption. The impact of a purchase or sinking fund is that the total number of shares outstanding gradually decreases. This reduces marketability of the issue, but tends to support the share price.

Types of Preferred Shares

There are four different types of preferred shares: retractable, fixed rate, fixed reset and floating rate as described below.

Retractable

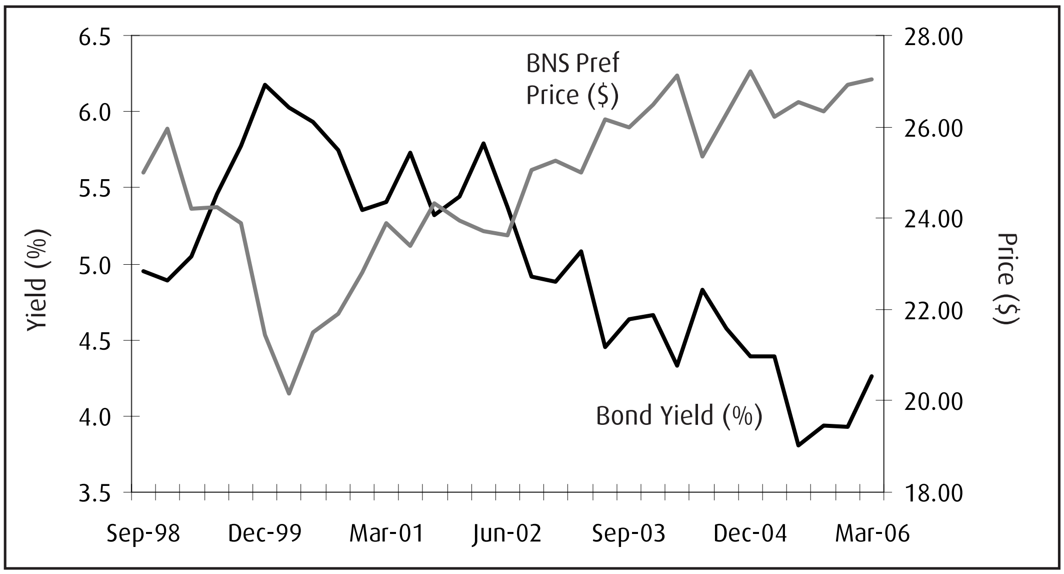
A retractable preferred share offers the holder the privilege to return their shares to the issuer for a specified price (usually par value) on a specified date. A retractable share is valued primarily on its yield-to-retraction, which is the return based on receiving dividends plus a capital gain or loss upon retraction. A retractable preferred share is considered to be defensive as the retraction feature lends price support in a rising interest rate environment. In turn, the yield on a retractable preferred share is among the lowest in the sector. In recent years, the new issuance of retractable preferred shares has fallen dramatically as other types of preferred shares offer issuers greater financial flexibility.

Fixed Rate ("Straight")

A fixed rate "straight" preferred share does not offer a retraction feature. It pays a fixed dividend rate and is valued on its current yield (i.e., dividend / market price). If the redemption date is approaching, an investor should focus on the yield-to-redemption, which is the return based on receiving dividends plus a capital gain or loss upon redemption.

As redemption is the issuer's privilege and is not mandatory, a fixed rate preferred share is considered to have a very long (or "perpetual") term. As such it will be more sensitive to changes in interest rates than a retractable preferred share *(Chart 1)*. Given its sensitivity to interest rates, an investor must be prepared to accept fluctuations in market value as rates change over time. A fixed rate preferred share offers among the highest yield in the sector, appealing to investors who are highly income-oriented. In recent years, the new issuance of fixed rate preferred shares has increased substantially.

Chart 1
BNS Preferred Price vs 10 Year Bond Yield



Source: Nesbitt Burns

Fixed Reset

A fixed reset preferred share offers a fixed dividend for a specified number of years (usually five) and thereafter is subject to reset every five years. As there is no retraction privilege, a fixed reset preferred share is considered to have a very long (or "perpetual") term. However, the periodic reset feature is designed to minimize the impact of changes in interest rates over time, as it brings the dividend into line with current market yields. As a consequence, a fixed reset preferred share will outperform a fixed rate issue if interest rates rise. This defensive feature appeals to an investor who is seeking a relatively high yield, but who is concerned about rising interest rates.

Floating Rate

A floating rate preferred share pays a dividend that is based on Canadian prime rate (prime). The dividend rate will range from 50% to 100% of prime, depending on the particular issue. Because its dividend is linked to the prime rate, a floating-rate preferred share tends to appreciate when rates are rising, or anticipated to rise, and depreciate during periods of falling rates, all else equal.

U.S. Pay

Some Canadian preferred shares are denominated in U.S. dollars. These issues are listed on the S&P/TSX and pay U.S. dollar dividends. As the issuers are Canadian entities, they are eligible for the dividend tax credit. Income-oriented individuals who have U.S. dollars to invest enjoy the benefits offered by U.S.-pay preferred shares.

Appendix A — Preferred Share Rating Scale

Dominion Bond Rating Service

P-1 **Superior quality.** Supported by strong earnings and balance sheet characteristics. Generally corresponds to companies whose senior bonds are rated 'AA' to 'AAA'.

P-2 **Satisfactory quality.** Protection of dividends and principal is still substantial, but earnings, balance sheet, and coverage ratios are not as strong as P-1 rated companies. Generally corresponds to companies whose senior bonds are rated 'A'.

P-3 **Adequate quality.** While protection of dividends and principal is still considered acceptable, the issuer is more susceptible to adverse changes in financial and economic conditions, and there may be other adversities present which detract from debt protection. Generally corresponds to companies whose senior bonds are rated in the higher end of the 'BBB' category.

P-4 **Speculative.** The degree of protection afforded to dividends and principal is uncertain, particularly during periods of economic adversity. Generally corresponds to companies whose bonds are rated 'BB' to the lower end of the 'BBB' category.

P-5 **Highly speculative.** The ability of the issuer to maintain timely dividend and principal payments in the future is highly uncertain. Generally corresponds to companies whose bonds are rated 'B' or lower. May have characteristics that, if not remedied, may lead to default.

Standard & Poor's Rating Service

P-1 **Highest quality.** The issuer's capacity to meet its financial commitment is extremely strong.

P-2 **Adequate quality.** Exhibits adequate protection parameters. Adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to meet financial commitments.

P-3 **Somewhat speculative.** Less vulnerable to non-payment than other speculative issues, however, faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions that could lead to inadequate capacity to meet financial commitments.

P-4 **Speculative.** More vulnerable to non-payment than P-3 rated obligations, but the issuer currently has the capacity to meet financial commitments. Adverse business, financial, or economic conditions will likely impair the issuer's capacity or willingness to meet financial commitments.

P-5 **Highly speculative.** Currently vulnerable to non-payment and dependent upon favourable business, financial, and economic conditions in order to meet financial commitments. In the event of adverse business, financial or economic conditions, the issuer is unlikely to have the capacity to meet financial commitments.

Appendix B — Exchange Feature

Preferred shares that allow the issuer to pay redemption and/or retraction proceeds with their common shares in lieu of cash are known as exchangeable preferred shares. The number of common shares to be distributed is determined by the following formula:

The preferred share cash redemption price (plus declared and unpaid dividends) is divided by the greater of $1.00 and 95% of the weighted average trading price of the common shares during a specified 20 business day period.

Example: Westcoast Energy 8.08% Cumulative First Preferred Share Series 2 was redeemed on October 29, 2001. The issuer chose to pay redemption proceeds with their common shares instead of $25 cash per preferred share. The average weighted trading price for Westcoast common for the 20 day period between September 27, 2001 and October 25, 2001 was $41.28. When shares were distributed on October 29, 2001 Westcoast common was trading at $41.90.

Preferred shareholders received 0.6375 Westcoast Energy common shares calculated as follows:

$$\frac{\$25.00}{0.95 \times \$41.28}$$

$$\frac{\$25.00}{\$39.22}$$

= 0.6374 Westcoast Energy common shares

Redemption value of the common shares:

0.6374 x $41.90

=$26.70

RT11240 (05/06)

BMO Nesbitt Burns®