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Preferred Shares

An Introduction

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"Preferred Share" is a class of equity that ranks senior to common equity. Preferred shares are an important source of capital for Canadian corporations and financial institutions, and are a popular income investment. Income-oriented investors are attracted to the relatively high and tax efficient dividends that preferred shares pay. In this publication, we take a look at the Canadian preferred share market and the different types of shares in the marketplace.

Credit Ratings

As payment is not a legal obligation, preferred shares are generally viewed as higher risk investments than high-grade bonds and GICs. Consequently, it is important to consider an issuer's financial condition and business outlook, which are reflected in its credit rating. Two Canadian credit rating agencies — Dominion Bond Rating Service and Standard and Poor's Rating Service — use a rating system ranging from "P-1" (highest) to "P-5" (lowest). A "high" or "low" designation may also be used to indicate a company's relative strength within a rating category. Definitions of these ratings are provided in Figure 1.

Preferred shares that are rated P-1 or P-2 are considered to be among the strongest credits. Financial institutions and companies with relatively stable operations and revenue are typically granted such ratings. Shares in this rating category are usually recommended for conservative income-oriented investors.

A P-3 rating is generally reserved for businesses that are sensitive to economic cycles and/or whose debt is relatively high. Issues that are rated P-4 are considered to be speculative and, as such, are not recommended for income oriented investors.

In the credit markets, issues with a weak credit rating are viewed as being at higher risk for non-payment. Moreover, they tend to lack liquidity and may exhibit greater price variability over time than higher-rated issues.

Figure 1: Credit Rating Definitions

Category	Definition
P-1	Preferred Shares in this category are considered superior credit quality and are 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 considered 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 considered 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 higher end of the BBB category.
P-4	Preferred shares in this category are considered speculative. The degree of protection afforded to dividends and principal is uncertain particularly during periods of economic adversity. Companies with preferred shares rated P-4 generally coincide with entities that have bond ratings ranging from the lower end of the BBB category through the BB category.
P-5	Preferred shares in this category are considered highly speculative, and 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 preferred shares that are in arrears of paying either dividends or principal.

Member-Canadian Investor Protection Fund

All figures in C$ unless otherwise noted

Dividends

Most preferred shares are issued with a $25.00 par value. The annual dividend (or "coupon") is expressed as a percent of par value (such as 5.20%) or a dollar amount (such as $1.30). Dividends are usually paid quarterly.

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

Preferred share dividends are either "cumulative" or "non-cumulative." Technically speaking, a cumulative dividend, if suspended, would accrue and would have to be paid in full before common dividends could be reinstated. A non-cumulative dividend, if suspended, would not accumulate. Typically, dividends on financial issues are non-cumulative while dividends on corporate issues are cumulative. Notwithstanding these descriptions, a company that is financially stable will always pay dividends on schedule.

Canadian issuers pay preferred share dividends out of after-tax earnings. Consequently, by the time shareholders receive their dividends, they have already been subject to tax. To alleviate double taxation, individual investors are entitled to the Dividend Tax Credit. The effect of the tax credit is that the tax rate on eligible dividends is significantly lower than the rate for interest income. In Figure 2 we highlight the combined (Federal and Provincial) top marginal tax rates for individuals in 2012.

Figure 2: 2012 Combined Top Marginal Tax Rates by Province

Province	Eligible Dividends	Salary & Interest	Gross-Up Factor	Capital Gains
Alberta	19.29%	39.00%	1.323	19.50%
B.C.	26.11%	43.70%	1.312	21.85%
Manitoba	28.12%	46.40%	1.341	23.20%
New Brunswick	22.47%	43.30%	1.367	21.65%
Newfoundland	22.47%	42.30%	1.344	21.15%
Nova Scotia	36.06%	50.00%	1.279	25.00%
Ontario	29.54%	46.41%	1.315	23.20%
Prince Edward Island	28.70%	47.37%	1.355	23.69%
Quebec	32.81%	48.22%	1.298	24.11%
Saskatchewan	24.81%	44.00%	1.343	22.00%

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

Redemption Features

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. Since all preferred shares have a redemption schedule, an investor should take the "yield-to-redemption" into account when making an investment decision. If there are several redemption dates, an investor should consider the lowest possible yield, which is referred to as the "yield-to-worst."

An issuer's decision to redeem a preferred share or leave it outstanding will depend on its financing options, credit market conditions and investor demand. Issues that are expected to be redeemed within a relatively short period of time will trade close to their redemption price.

Certain issues allow for the payment of redemption proceeds with the issuer's common shares rather than cash. This is known as a "soft redemption" feature. This feature is rarely exercised, as it increases the number of common shares outstanding and, in turn, dilutes common equity. An issuer would likely only exercise this privilege if cash were not readily available.

Under a soft redemption, the number of common shares that one would receive for their preferred shares would be calculated as follows:

$$= \frac{\text{Redemption price (plus accrued and unpaid dividends)}}{\text{The greater of: (a) \$2.00; and (b) 95\% of the weighted average trading price of the common shares during a specified 20-business day period.}}$$

Example: ABC Co. 5.00% Redeemable Preferred Shares were redeemed in October 2012. The issuer chose to pay redemption proceeds with its common shares. The weighted average trading price for ABC Co. common during the specified 20-day period was $41.28. The number of common shares that were distributed to the preferred shareholders was calculated as follows:

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

$$= \frac{\$25.00}{\$39.216}$$

$$= \underline{0.6375}$$

When the common shares were distributed, ABC Co. was trading above the 20-day average at $42.00. Consequently, when shareholders received 0.6375 common per preferred share, the market value was $26.77 (= 0.6375 x $42.00). This was a positive outcome. However, had ABC Co. common shares been trading lower due to dilution and/or fundamental challenges, the redemption proceeds could have been substantially lower than anticipated.

Types of Preferred Shares

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

Retractable

Retractable preferred shares pay fixed quarterly dividends and contain a “retraction feature.” A retraction feature allows the holder to tender their shares back to the issuer on specified dates for par value. The first retraction date is usually within 10 years of inception, and the feature is considered defensive as it helps support the share’s market price at around par value.

While a retraction feature usually supports the share’s market price, 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 difficulty, the value of the preferred share would fall substantially and shareholders would suffer a loss. Furthermore, shareholders would have no legal recourse.

Retractable preferred shares are popular with investors because their market price tends to be relatively stable over time. However, most companies prefer to issue shares that can remain in the market for a long period. Consequently, the issuance of retractable preferred shares has declined substantially over the past decade and the sector represents less than 5% of the Canadian preferred share universe today.

Straight

Straight preferred shares pay fixed quarterly dividends 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 or “perpetual” term. Because longer-term securities are more sensitive to fluctuations in interest rates than shorter-term securities, investors who buy straight preferred shares must be prepared for more price variability over time than would typically occur with a retractable issue.

Straight preferred shares are the highest-yielding type of preferred share because investors must be compensated for the risk of holding a long-term security. While not as popular with investors, issuers enjoy the straight perpetual structure because they can lock in equity capital at a fixed rate for a long period. In particular, the Canadian banks have traditionally been large issuers of straight preferred shares because the structure qualifies for Tier 1 Capital. Straight preferred shares currently represent 34% of the Canadian preferred share universe.

Rate-Reset

Reset preferred shares have existed in the marketplace for many years, but the sector has grown substantially since 2008. Today, the sector makes up the majority of the Canadian preferred share universe at 58%. In this publication we focus on a new type of reset preferred share called "Rate-Reset."

Rate-Reset preferred shares pay a quarterly dividend that is fixed until the "reset date," which is usually five to seven years after inception. On the first reset date, the shares will either be redeemed by the issuer at $25.00 or the coupon will automatically reset at a specified spread over the five-year Government of Canada bond yield. The coupon resets in this way every five years as long as the shares remain outstanding. Most issues also offer holders the option of exchanging their shares for a floating-rate series whose dividends are based on the 90-day Canada T-bill yield plus the same fixed reset spread. The reset feature is described in the example below.

DEF Inc. 4.00% Rate-Reset Preferred Shares were issued in September 2012. The coupon rate was initially set at 4.00% ($1.00 per annum), which equated to the five-year Canada bond yield at the time plus 2.40%. The initial 4.00% coupon rate is payable until September 31, 2017. At that time, if the shares are not called for redemption by the issuer, the coupon rate will automatically reset to the five-year Canada bond yield in effect at that time, plus 2.40%.

Let's assume that the five-year Canada bond yield is 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. The coupon rate would be reset in this manner every five years as long as the shares remained outstanding.

Rate-Reset preferred shares are redeemable at the issuer's option every five years at $25.00. The decision to redeem the 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 capital at a lower spread than the reset spread on the existing issue, they would likely redeem the existing shares. If not, they would likely allow the existing shares to reset. This ability on the issuer's part to redeem an issue or let it reset adds an element of risk that is called "reset risk" or "extension risk."

If a coupon is allowed to reset, its competitiveness in the marketplace will be dependent on where credit spreads are at that time. For example, in 2017 when DEF Inc. Preferred Share is resettable, it's likely that companies of similar credit quality will be issuing preferred shares. If these new issues are priced at a more attractive credit spread than 2.40%, DEF's newly reset coupon rate may not be seen as competitive and its share price will likely come under pressure.

Floating Rate

Floating-Rate preferred shares pay a dividend that is based on the Canadian prime rate or the 90-day Canada T-bill yield. 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 3% of the Canadian preferred share universe.

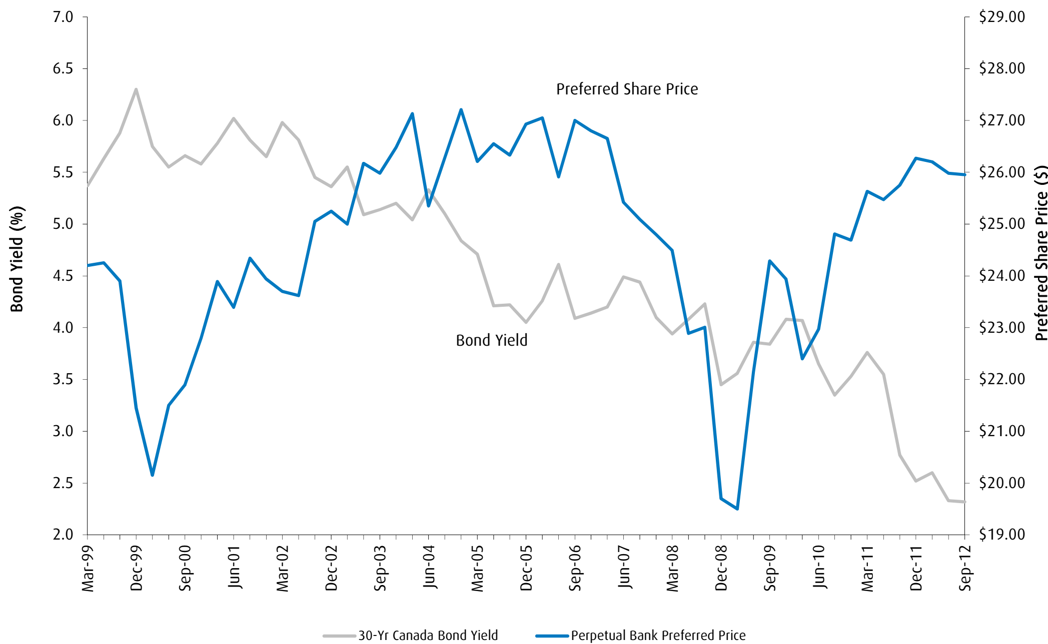
Factors that Affect Preferred Share Prices

The 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 securities that pay a fixed distribution are sensitive to interest rate movements to some degree. 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-1999 and late-2012.

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

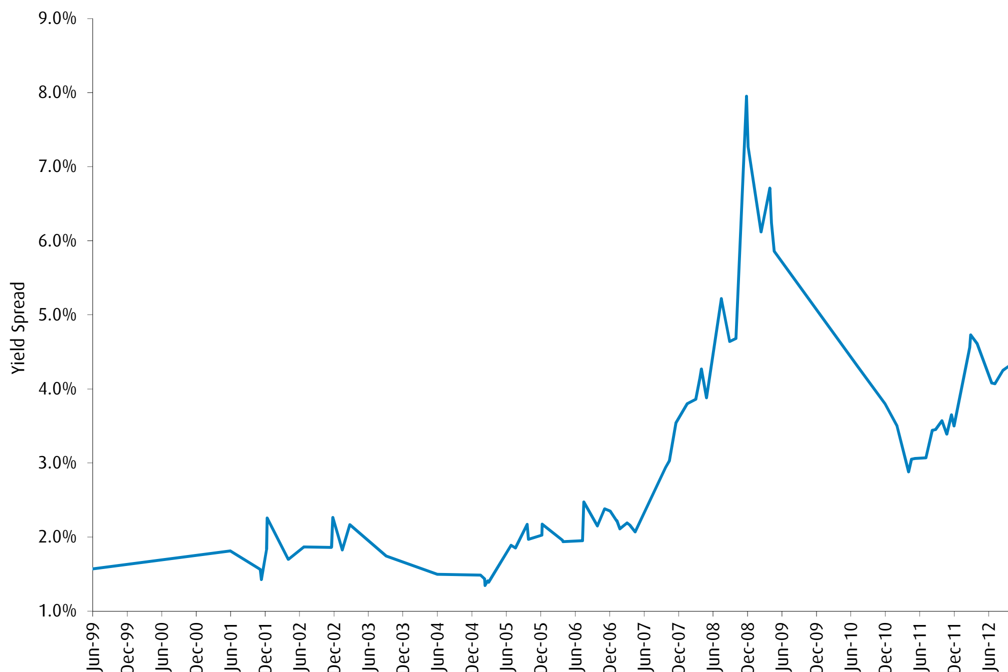


Source: BMO Nesbitt Burns

Credit Markets

Credit market conditions are reflected in the yield differential (the "credit spread") between Government of Canada bonds and preferred shares. Typically, spreads will narrow during periods of economic prosperity and widen during periods of economic uncertainty. The most dramatic recent example of this was seen during the 2008 Financial Crisis when credit spreads spiked to unprecedented levels, causing preferred share prices to plummet. Figure 4 highlights the movement in credit spreads on a typical straight preferred share between mid-1999 and late-2012.

Figure 4: Straight Preferred Share Credit Spread vs. Long-Term Canada Bond Yield (Pre-Tax Interest Equivalent)



Source: BMO Nesbitt Burns

Issuer Fundamentals

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

Liquidity

The $59 billion market capitalization of the Canadian preferred share market is relatively small compared to approximately $410 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. 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 and debentures and high dividend yield common equities can help enhance returns without adding undue risk. Liquidity in the preferred share market is limited however, and investors must consider the creditworthiness of the issuer prior to making an investment decision.

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