Hybrids (1): Preference shares

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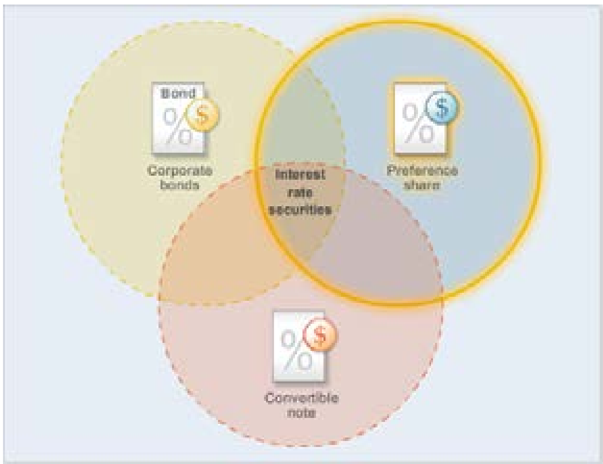
Topic 1: Overview

Three main types of interest rate security are traded on ASX:

- corporate bonds/notes
- preference shares, and
- convertible notes.

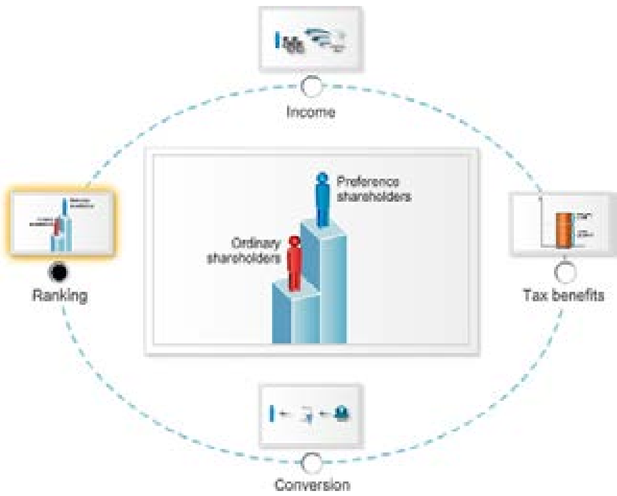


Preference shares are the focus of this module. We look at their features, benefits and risks.

At the end of the module there is a case study of a preference share listed on ASX.

Why invest in preference shares?

- You receive a defined income in the form of dividends.
- Dividends paid on preference shares may have franking credits attached, which can give you tax benefits.
- Preference shares typically convert into ordinary shares at a future date.
- You rank ahead of ordinary shareholders for the payment of dividends.
- You rank ahead of ordinary shareholders for recovery of capital if the company becomes insolvent.



What is a preference share?

A preference share is a 'hybrid' security, meaning it has features of both debt and equity.

Debt characteristics

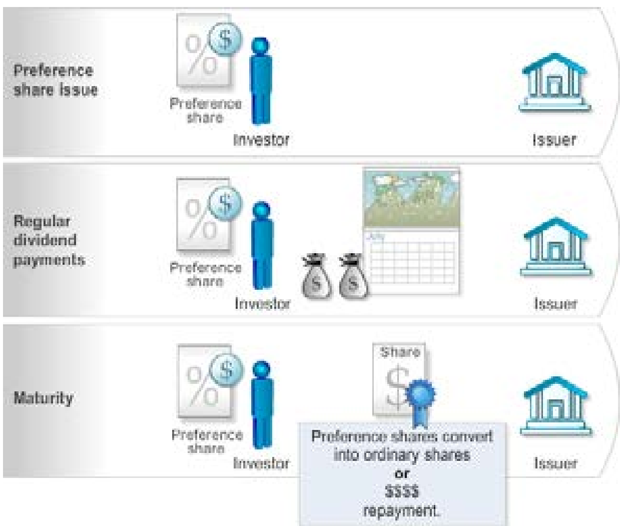
A preference share:

- pays a regular defined income stream, and
- generally has a fixed maturity date.

Equity characteristics

A preference share:

- pays income in the form of dividends, and
- generally converts into ordinary shares at some future point.

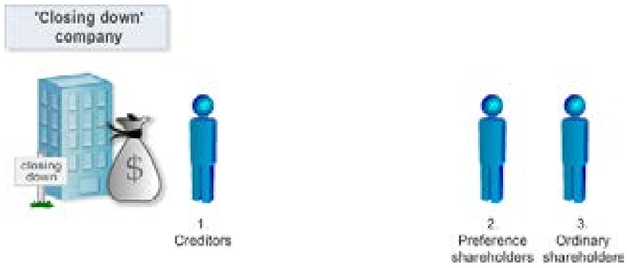


What is a preference share? (cont)

The term 'preference' indicates that you rank ahead of the company's ordinary shareholders for the payment of dividends, and have a prior claim on the company's assets if the company is wound up.

However you rank behind the company's creditors.

Most preference shares are 'converting' (or 'convertible'), signifying that at some point they may be converted into ordinary shares in the company.

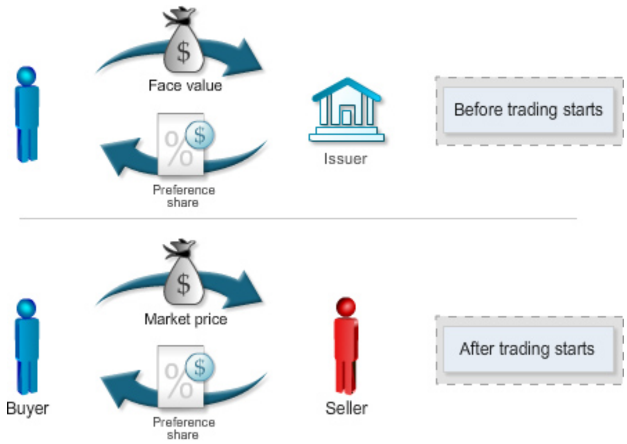


Buying preference shares

At the time of issue, you can subscribe for preference shares directly from the company - just as you would apply for shares in a float. You will pay face value for your preference shares.

Once the issue period is finished, the preference shares start trading on ASX.

If you buy preference shares on market, you buy from another investor, not from the issuing company. You will pay the market price.



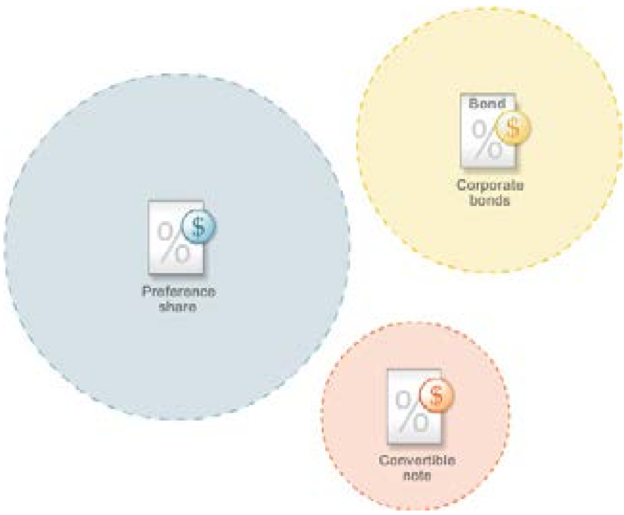
The preference share market

Three main types of interest rate security are traded on ASX:

- corporate bonds/notes
- preference shares, and
- convertible notes.

Preference shares are the largest sector of the interest rate security market, with a market capitalisation of $15.3 billion, which is about 70% of the market (April 2010).

Many preference share issues are of significant size. The major banks in particular have used preference share issues to raise funds, with several issues of over $1 billion. There tends to be active trade and good liquidity in these issues.



For up-to-date statistics, please refer to ASX's monthly report on trading in the interest rate securities market.

What should I look for in a preference share?

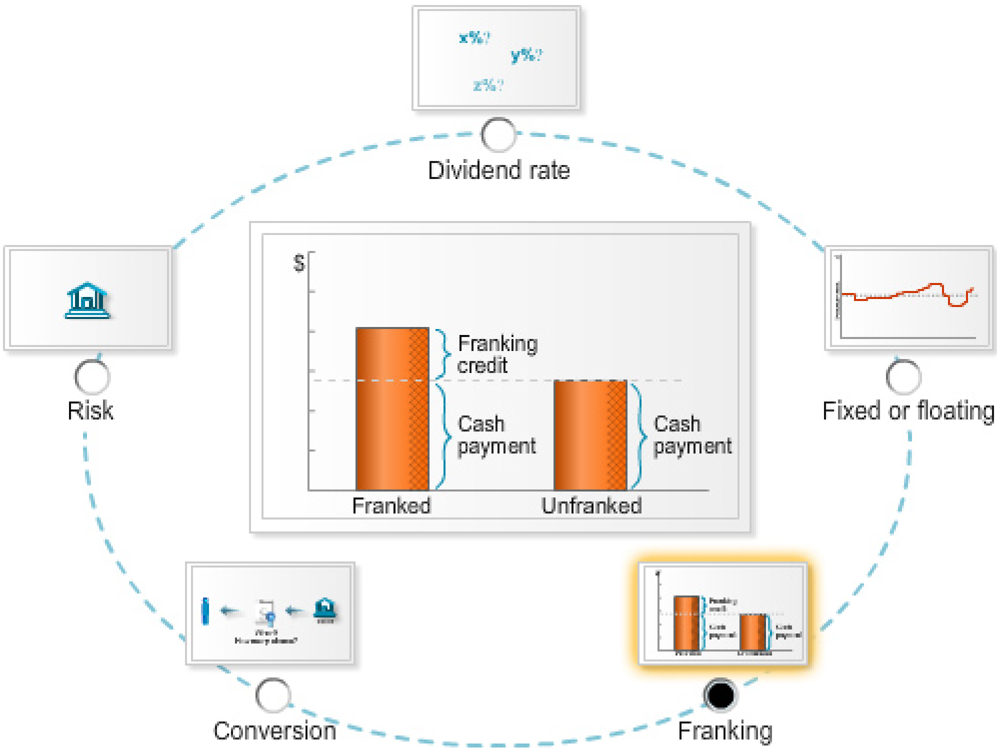
The most important information to know about a preference share is:

- dividend rate
- whether the dividend is fixed or floating
- whether the dividend is franked, and
- how and when the preference share converts into ordinary shares.

It is also essential to consider the risk associated with the company that issues the preference shares.

The features and risks of preference shares are covered in the next three topics of this module.

Features of preference shares can vary significantly. You should read the prospectus carefully to ensure you are fully informed.



Topic 2: Income

Dividends

Preference shares pay income in the form of dividends.

There are some important differences between preference share dividends and dividends paid on ordinary shares.

Percentage rate

Dividends on preference shares are typically expressed as a percentage of the preference share's face value.

Dividends on ordinary shares are expressed in cents per share.

Dividend rate	Type of share
$ x.xx per share	Share Ordinary share
x% of face value	Preference share

Dividend rate set at time of issue

The rate of payment on a preference share is set at the time of issue.

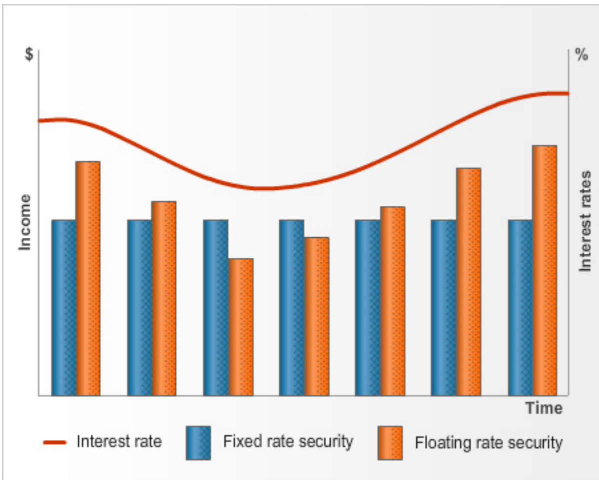
In contrast, dividends paid on ordinary shares can be varied at the company's discretion.

If your preference shares pay 'floating' dividends, your payments vary in line with market interest rates. The issuer specifies:

- the benchmark rate to be used e.g. the bank bill swap rate (BBSW), and
- a margin to be added to the benchmark e.g. 3.0%.

If your preference shares pay 'fixed' dividends, your payments do not vary. The issuer specifies a percentage of the face value to be paid per year.

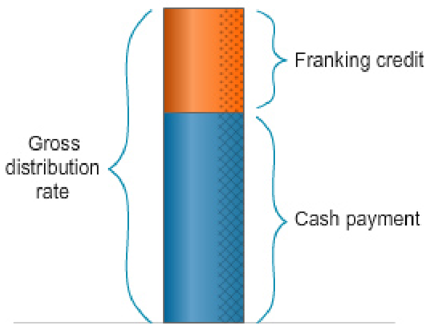
Dividends on preference shares are paid either quarterly or semi-annually (twice a year).



Published payment rate

Like dividends paid on ordinary shares, dividends on preference shares may or may not be franked. The franking credit is a non-cash amount that must be added to your taxable income, but the credit can be used to offset tax payable on your earnings.

Gross distribution rate includes cash payment and franking credit.



The gross distribution rate (published distribution rate) on a preference share typically includes both the amount you receive in cash *and* the franking credit.

This rate is a 'gross' rate because it includes the value of the franking credit. The amount you receive in cash is therefore less than the published rate.

In contrast, the dividend paid on an ordinary share is expressed as the cash payment rate, so does not include the value of any franking credit.

How much cash do I get?

If you know the gross distribution on a preference share, calculating the cash payment is simple.

If a dividend is fully franked at the company tax rate of 30%:

- cash payment = gross distribution x 70%
- franking credit = gross distribution x 30%

While the cash you receive is less than the gross distribution, the franking credit can be offset against tax payable on your earnings.

If your preference share pays a 10% distribution as a fully franked dividend, you receive:
- 7% in cash, and
- 3% as a franking credit.

If your preference share pays an **8%** distribution as a fully franked dividend, you receive:
- 5.6% in cash, and
- 2.4% as a franking credit.

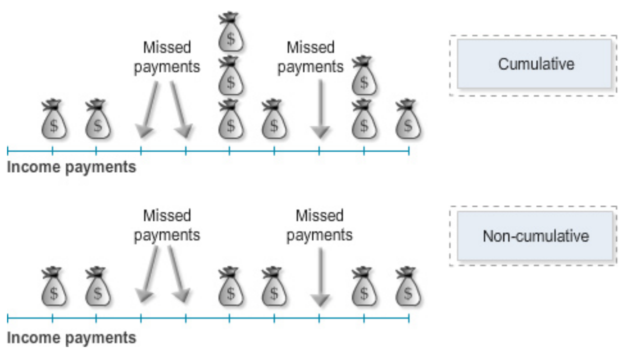
Distribution rates	Breakdown of distribution		Calculation
10%	Cash payment	7%	= 10% x 70%
	Franking credit	3%	= 10% x 30%
8%	Cash payment	5.6%	= 8% x 70%
	Franking credit	2.4%	= 8% x 30%

When might a dividend not be paid?

Preference shares rank above ordinary shares for dividend payments. Dividends on preference shares must be paid in full before ordinary shareholders receive a dividend.

What happens if the issuer misses a dividend payment?

The consequences of a missed dividend depend on whether payments are 'cumulative' or 'non-cumulative'. This will be specified in the prospectus.



If dividends are **cumulative**, the issuer must add the missed amount to future payments. In other words, missed payments accumulate until they are paid.

If dividends are **non-cumulative**, a missed payment is foregone forever.

Do changes in market interest rates affect my dividends?

The effect of a change in interest rates depends on whether your preference shares pay a floating or fixed dividend rate.

If your preference shares pay a floating rate, your dividends move in line with market rates. If interest rates rise, the income you receive will also increase. However, if rates fall, your income will decrease.

If your preference shares pay a fixed rate, your dividends stay the same regardless of changes in market interest rates.

Interest rates	Floating rate dividends	Fixed dividends
↑	up	unchanged
↓	down	unchanged

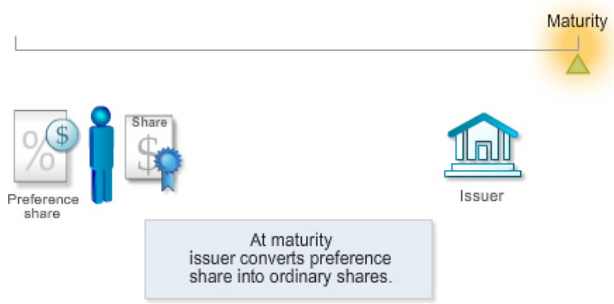
Topic 3: Getting your money back

Generally you can get your money back either at maturity or before.

At maturity

If you hold preference shares to maturity, you get your money back in the form of ordinary shares.

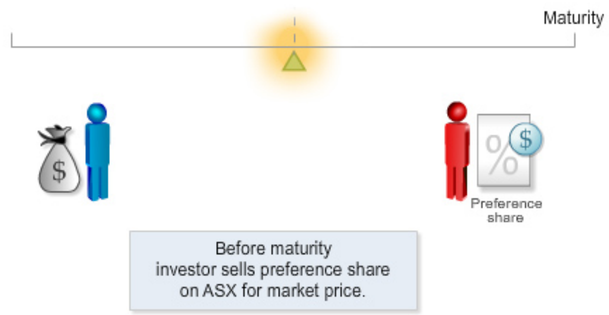
Your preference shares are converted into ordinary shares in the company.



Before maturity

If you want to exit your investment before maturity, you will have to sell on ASX.

There is no guarantee you will receive face value for your preference shares when you sell on market. The market price at the time you want to sell may be above or below face value.



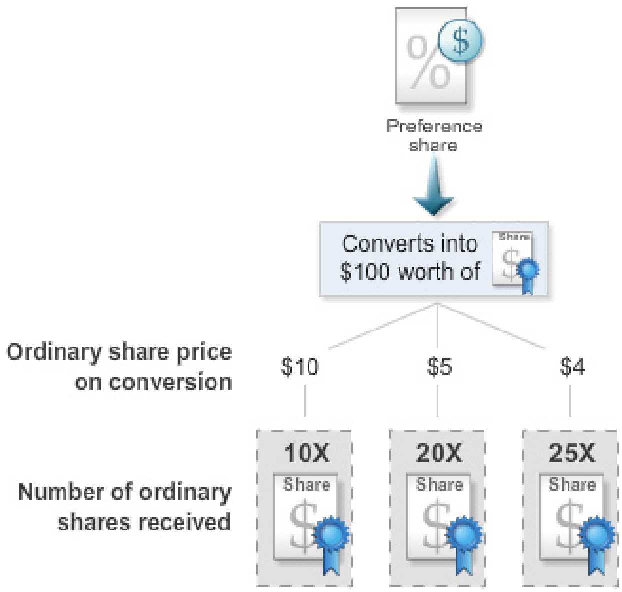
How many ordinary shares will I receive on conversion?

The number of shares you receive depends on the conversion mechanism specified in the prospectus.

Most preference shares convert into a fixed dollar value of ordinary shares. Typically you receive the face value of the preference share in the form of ordinary shares.

The higher the market price of the ordinary shares at conversion, the fewer shares you receive. The lower the price of the ordinary shares, the more you receive.

For example, if a preference share converts into $100 worth of ordinary shares, and the ordinary share price at conversion is $5.00, you would receive 20 ordinary shares for each preference share.



What ordinary share price is used to calculate conversion?

The share price used in the conversion formula is usually an average traded price over a specified period leading up to the conversion date. This is referred to as a 'volume weighted average price' (VWAP).

The prospectus may specify that conversion is done at a discount to the VWAP.

Assuming the VWAP was $5.00, and a 5% discount was applied, the share price used to calculate the conversion would be $4.75. You would receive 21.05 shares per security (= $100/$4.75).

The larger the discount, the more favourable the conversion terms for you.

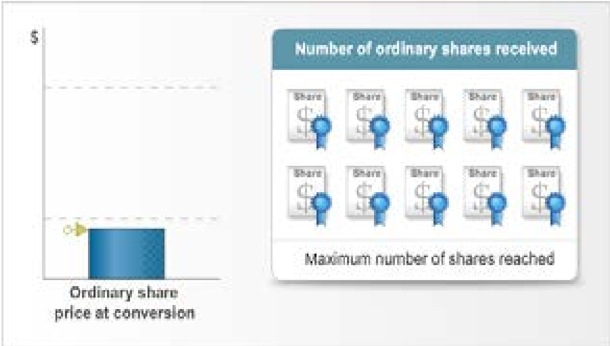
$ value of shares per preference share	VWAP	Discount	Price of ordinary shares used for conversion	No. shares received
$100	$10	10%	$9.00	11
$100	$7	5%	$6.65	15
$100	$6	8%	$5.52	18

Maximum and minimum number of shares

There is often a maximum and minimum limit to the number of shares you will receive on conversion.

If the price rises above a certain point, you are guaranteed a minimum number of shares - an advantage to you.

But if the share price at conversion is below a certain point, you do not receive any extra shares - a disadvantage to you.

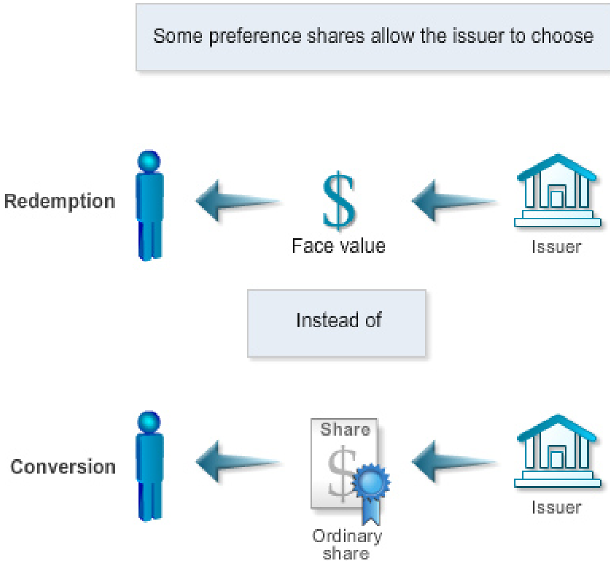


Cash payment instead of shares

Some preference shares give the issuer the choice of paying cash (redeeming) instead of converting the preference shares into ordinary shares. The holder has no control over which option the issuer chooses.

If the issuer elects to redeem your preference shares instead of converting them, you will be paid the face value of the preference shares in cash.

This cash payment of face value may be less than the value of shares you would have received on conversion. This is because the share price is discounted when calculating conversion into shares.



Mandatory conversion vs. reset preference shares

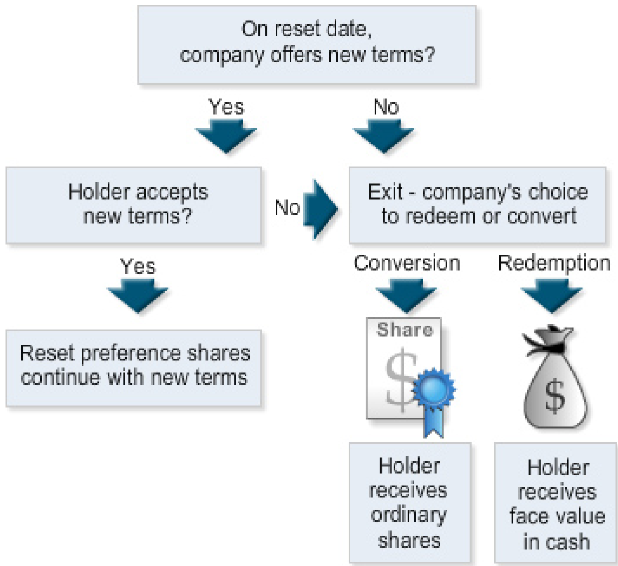
Most preference shares have mandatory conversion. On the specified maturity date, conversion into ordinary shares takes place automatically.

A variation on the mandatory converting preference share structure is the 'reset preference share'.

A reset preference share gives the issuer the choice, on specified 'reset' dates, to extend the term of the preference share on new terms. For example, the issuer may want to alter the dividend rate, or the conversion terms.

You can:

- accept the new terms, in which case your preference shares continue under the revised terms, or
- decline the new terms, in which case your preference shares will be converted into ordinary shares or redeemed for cash, depending on the original terms of the issue.



Step-up preference shares

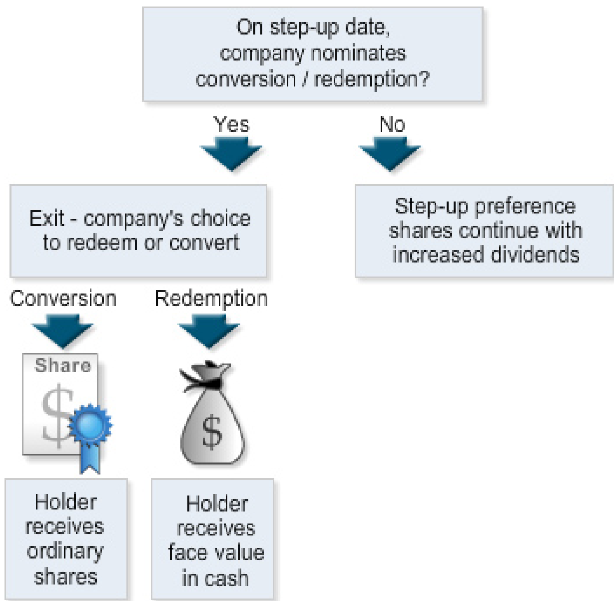
Another variation on the preference share is the 'step-up'.

The step-up mechanism is significantly different from the mandatory conversion mechanism of the converting preference share.

Specific terms can vary significantly between different issuers, but the key features of step-ups typically are:

- no maturity date (perpetual)
- on specified date(s) ('step-up dates') the issuer has the right to redeem or convert the preference share
- if the issuer chooses not to redeem or convert the preference shares, dividends paid to holders increase by a 'step-up margin'
- the holder has no right to redeem or convert.

Few recent issues have been step-ups, as investors generally have sought the certainty of the mandatory conversion mechanism.



Topic 4: Return and risk

Calculating your returns

Your return from a preference share comprises:

- dividends, and
- any capital gain or loss you make.

Total return = dividends + capital gain/loss

You will make a capital gain or loss if there is a difference between the price you pay for the preference shares and the value you receive on exiting your investment.

Your exit value depends on whether you:

- hold your preference shares until conversion takes place, or
- sell your preference shares on ASX.

Holding until conversion

Your exit value is the market value of ordinary shares your preference share converts into.

Face value of preference share	Market price of ordinary shares	Discount applied	Discounted price of ordinary shares	Number of ordinary shares received	Market value of ordinary shares received
$100	$5.12	7%	$4.76	21.01	$107.57
	$7.00	5%	$6.65	15.04	$105.28
	$12.90	3%	$12.51	7.99	$103.07

A discounted value is generally used for the ordinary shares when converting from preference shares. The actual market value of the ordinary shares you receive is greater than the face value of the preference share.

Example

Your preference share:

- has a face value of $100, and
- applies a 5% conversion discount to the ordinary share price.

If the market price of the ordinary shares at the time of conversion is $5.00, the share price used to calculate the conversion is $4.75. You receive 21.05 shares per preference share (= $100/$4.75).

The market value of ordinary shares you receive is:

21.05 shares x $5.00 = $105.25

Assume you paid $100 for your preference shares. Your capital gain is $5.25.

Selling on ASX

If you want to exit your investment before maturity, you will have to sell on ASX.

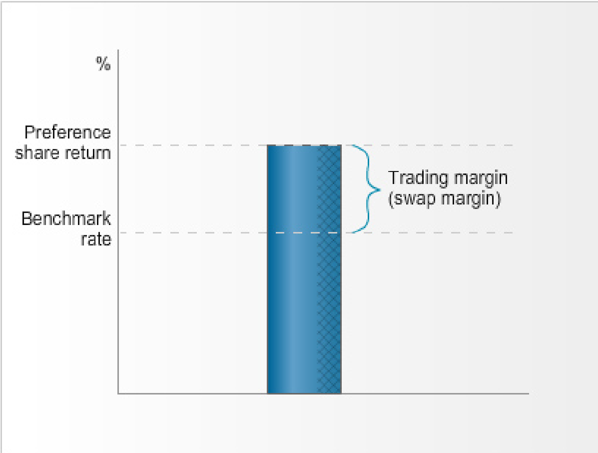
There is no guarantee you will receive face value for your preference shares when you sell on market. The market price at the time you want to sell may be above or below face value.

Your capital gain/loss depends on the difference between the price you paid for your preference shares, and the price you receive when you sell them.

Buy	Sell/hold to conversion	Result
At issue	Sell on ASX < face value	Capital loss
On ASX < face value	Sell on ASX > face value	Capital gain

Measuring your return

There are various measures of what your return will be if you hold your preference shares until conversion. Some brokers can provide these.



Fixed rate preference shares

A preference share's 'yield to maturity' captures both dividends and any capital gain or loss if you hold your shares until conversion.

Floating rate preference shares

Calculating returns is more difficult if your preference shares pay a floating rate, as the size of future dividends is unknown.

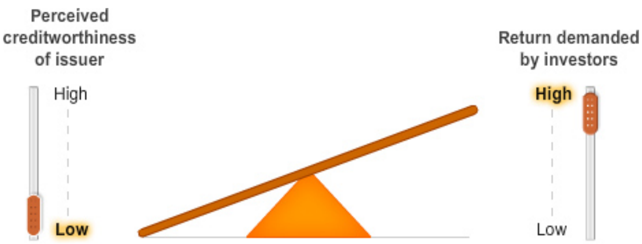
One useful measure is the 'trading margin', or 'swap margin', which is the difference between:

- the benchmark rate, and
- the return from the preference share including both dividends and capital gain/loss.

For more information on measures of return, refer to Module 2, 'Income'.

Higher return - higher risk

If investors think a company is high risk, they will demand a high return.



If a preference share offers unusually high returns, it may be because the market thinks there is a risk the company will default on its payment obligations.

Conversely, if a company is seen as low risk, it may not have to offer such a high dividend on its preference shares in order to attract investors.

One approach is to compare the return from a preference share to a low-risk market reference rate such as the bank bill swap rate. Then consider whether the margin above the reference rate is a fair reflection of the risk of the preference share and the issuer. The margin can also be compared to the margins on similarly structured hybrids issued by other companies in the same industry.

Risk of capital loss

If you sell your preference shares prior to maturity, you will receive the market price. Depending on what you paid for them, you may make a capital loss.

You will also make a capital loss if you buy your preference shares on ASX, hold them until conversion, and the amount you paid for the preference shares is more than the value of the ordinary shares you receive on conversion.

Buy	Sell / hold to maturity	Capital loss possible?
On market	Hold to maturity	Yes
On market	Sell on market	Yes
At time of issue	Hold to maturity	No
At time of issue	Sell on market	Yes

Risk of capital loss (cont)

In normal market conditions, the risk of capital loss from a preference share is generally lower than for ordinary shares, as the preference share price typically does not fluctuate as much.

Movements in the ordinary share price tend to have little effect on the preference share price, as the preference share converts into a fixed dollar value of ordinary shares. You get the same value of ordinary shares on conversion, regardless of the price of the ordinary shares.

Note that in times of high market volatility, preference share prices can fall significantly.

Topic 5: Case study - PERLS V

The previous topics have looked at the features, benefits and risks of preference shares. Now let's take a look at a preference share currently quoted on ASX to illustrate what has been discussed.

What are PERLS V?

- PERLS V is an acronym for **P**erpetual **E**xchangeable **R**esaleable **L**isted **S**ecurities ("**PERLS V**"), which are stapled securities comprising:
  - an unsecured subordinated Note issued by the Bank's New Zealand branch; and
  - a Preference Share issued by the Bank.
- These two securities cannot generally be traded separately.

In 2009, Commonwealth Bank of Australia (CBA) announced an issue of securities called Perpetual Exchangeable Resaleable Listed Securities (PERLS V).

PERLS V are preference shares with a face value of $200. Stapled to each preference share is an unsecured subordinated note.

Income

PERLS pay a floating rate of income. Distributions are paid quarterly. Early distributions have been fully franked, and the intention is that distributions will continue to be fully franked.

Floating rate Distributions

- PERLS V entitle Holders to quarterly Distributions, expected to be fully franked, that are subject to the Payment Tests.
- Distributions are expected to comprise Interest on the Notes.
- The Distribution Rate will be calculated each quarter as the Bank Bill Swap Rate plus the Margin of 3.40%, together multiplied by (1 – Tax Rate).
- Assuming the Bank Bill Swap Rate is 3.2800%1, the cash Distribution received by a Holder would be 4.6760% per annum (assuming Distributions are fully franked). The fully franked Distribution Rate of 4.6760% per annum would be equivalent to an unfranked Distribution Rate of 6.6800% per annum if the potential value of the franking credits is taken into account in full.

The gross distribution rate per annum is calculated as:

- the Bank Bill Swap Rate (BBSW), plus
- a margin of 3.40%.

The cash distribution is the gross distribution rate x (1 - company tax rate).

Example

If the BBSW is 3.28%:

- gross distribution = 3.28% + 3.4% = 6.68%
- cash distribution = 6.68% x (1 - .30) = 4.676%.

Income

Distributions are non-cumulative i.e. if part or all of a distribution is not paid, it will not be made up at a later stage.

Floating rate Distributions (continued)

- Distributions are non-cumulative. If a Distribution or part of a Distribution is not paid on a Distribution Payment Date, Holders have no claim or entitlement in respect of non-payment nor any right to receive that Distribution at any later time.
- Distributions are discretionary. If Distributions are not paid on PERLS V, a Dividend Stopper will restrict the Bank from paying dividends, interest or distributions or returning capital on Bank Ordinary Shares and certain other securities.

However, if CBA misses a payment to holders of PERLS, the bank cannot pay dividends, interest, or other distributions, or return capital to holders of ordinary shares and certain other securities.

Conversion/repayment

PERLS are perpetual, however there is an 'initial conversion date' of 31 October 2014.

On this date, the issuer can elect to arrange for holders to be paid face value ($200) in cash for their PERLS.

If the bank does not take this option, the PERLS will mandatorily convert into ordinary shares in CBA, as long as certain 'conversion conditions' are satisfied.

If conversion takes place, the holder of one PERLS will receive $202.02 worth of ordinary shares.

Exchange	PERLS V are expected to be Exchanged on 31 October 2014 (being the Initial Conversion Date) by one of the following methods. **Resale** • The Bank may arrange a Resale, where the Purchaser will acquire all PERLS V for $200 (the Face Value) each. **Conversion** • If Resale does not occur, PERLS V will Convert into a variable number of Bank Ordinary Shares worth approximately $202.02[1] if the Conversion Conditions are satisfied. **Repurchase** • If Resale and Conversion have not occurred, the Bank may, subject to APRA's prior written approval, elect to Repurchase all PERLS V for $200 (the Face Value) each. If PERLS V are not Exchanged on the Initial Conversion Date, the same possible outcomes will apply to each subsequent Distribution Payment Date until Exchange occurs.

Conversion/repayment

The conversion conditions, which are set out in the prospectus, include the requirement that the ordinary share price is above a certain level in a specified period before the conversion date.

If conversion/repayment does not take place on the initial conversion date, the same process takes place on the date of each subsequent distribution payment until conversion conditions are satisfied.

The holder has no right to request conversion or repayment.

Optional Exchange	• Holders have no right to request Exchange. • The Bank may, subject to APRA's prior written approval, Exchange all PERLS V if a Tax Event, Regulatory Event or NOHC Event occurs. • PERLS V must, subject to APRA's approval, be Exchanged if an Acquisition Event occurs.

Other features

Please note that this table contains summary information of the PERLS V offer. You should always read the full length prospectus for detailed information about any preference shares you are interested in.

PERLS V are trading on ASX. You can check the issuer's website or www.asx.com.au for updated information about this issue.

Summary

Preference shares pay a regular defined income stream in the form of dividends.

Most preference shares are 'converting' (or 'convertible'), signifying that at some point they may be converted into ordinary shares in the company.

Preference shareholders rank ahead of the company's ordinary shareholders for payment of dividends, and have a prior claim on the company's assets if the company is wound up.

The dividend rate may be fixed, or may vary in line with market interest rates. Dividends are paid either twice or four times a year.

The published dividend rate typically includes the value of any franking credits.

Most preference shares convert into a fixed dollar value of ordinary shares.

The higher the market price of the ordinary shares at conversion, the fewer shares you receive. The lower the price of the ordinary shares, the more you receive.

Most preference shares have mandatory conversion. On the specified maturity date, conversion into ordinary shares takes place automatically.

If you want to exit your investment before maturity, you will have to sell on ASX. You will receive the current market price, which may be more or less than face value.