Preference Shares Revisited

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Of the substantial capital issues currently available the least publicised and perhaps the least understood is of Preference shares. Whilst there have been half-hearted efforts to revive the tax-barred convertible Note issue, the public issue of Preference shares has never regained the popular interest of the early post-war period. Primarily because of this market disinterest companies have not utilised Preference capital for fund raising since that period and have since forgotten its usefulness as a component of capital structure.

Rights of Shareholders

A hybrid class carrying some of the features of a fixed interest stock, Preference capital is predominantly risk capital.

The essential difference between Preference shares and Debentures is that payment of dividends is a discretion left with the directors, whereas the penalties for non-payment of Debenture interest render interest a compulsory deduction from profit. However Preference dividends must be paid so long as Ordinary shareholders are receiving a distribution, but directors have the discretionary power to suspend both Ordinary and Preference dividends at any time this is deemed expedient.

Admittedly where a company's earnings are regularly more than adequate to meet Ordinary and Preference dividends, the Preference shares enjoy a high degree of security, and are well regarded by the general market. Also, at the other end of the scale, a company in severe financial straits may be unable to pay anything either on Preference shares or Debentures. At such times the Debenture holders have the legal right to liquidate the assets but in extreme cases this right may be worth very little.

Preference capital, or preferred capital, as it is sometimes called, has a preference in regard to dividend or capital or both over that applicable to Ordinary shares. The preference is expressed in terms of a rate of dividend which must be satisfied before the Ordinary shares become entitled to participate in profits and of an amount of capital ranking before Ordinary shares in the distribution of capital. Reflecting perhaps the changes in market conditions, the shares may have any combination of the following rights.

1. Cumulative — Dividends which have not been paid in previous years accumulate and represent a charge ahead of Ordinary dividend. Although profits may be earned there is no right to receive dividends, past or present, until a payment of Ordinary dividend is intended.

2. Redemption — Subject to the restrictions imposed by the Companies Acts the terms and conditions of the issue, set out in the Memorandum and Articles of Association, would specify a definite date for redemption. In certain cases this may be replaced by an option on the part of the company to redeem.

It is worth noting that Section 61 of the New South Wales Companies Act, No. 71, 1961, provides that proceeds of redemption must originate from either retained profits or a fresh issue of shares and any premium on redemption must be payable either from profits or share premium reserves.

3. Participation in benefits to Ordinary shareholders — The conditions of the issue may permit the holders to participate in distribution of profits beyond the contractual amount either up to a certain limit or pari passu with Ordinary shares without limit. Participation has extended, in certain

Although, as pointed out in the introduction to this article, Preference shares have never regained the popular interest of the early post-war period, the accompanying table indicates that the total amount raised by listed companies through Preference share issues has, proportionately, shown a rapid increase in the past two years and that the issue by one company alone will ensure a further sharp increase in the current year.

The article discusses the nature of this class of security, the circumstances in which they may be used, and propounds a method of grading and valuation.

It is not possible to forecast the future trend in Preference share raisings; this will be influenced in some cases by the particular capital requirements of the company, but in many cases the very shortage of capital may mean that potential borrowers must tailor the form of their capital raisings to meet the wishes and needs of the suppliers of capital. It is likely, therefore, that the Ordinary shareholder will be faced with more and more requests to consent to the amendment of the Memorandum and Articles of Association to allow the issue of Preference shares, and an understanding and appreciation of this class of security will make his decision easier.

cases, to cash issues of Ordinary shares.

Clearly the rights outlined above confirm the correct nomenclature given this type of capital. These shareholders run risks similar to the proprietors of the business but from a privileged position.

Because Preference shareholders are recognised as sharing in the business risks they are afforded the right to vote on matters relating to the conduct of a company's affairs. It does however require extreme conditions for this recognition to occur. In general the voting rights of Preference shareholders are inadequate to guard against intermittent interruption to their income, since the Articles of Association usually specify that Preference dividend must be six months in arrears before any voice in general policy can be claimed.

For example, two quarterly dividends can be missed before the theoretical right to vote may be invoked and even the practical difficulty arises that votes may be cast only at a general meeting. This may entail further months of delay, by which time the arrears may have been discharged and the Preference vote again silenced.

However any resolution which may directly affect their privileged position finds this class once again vested with singular voting rights. Any proposed action to be taken by the company which directly (and in some cases indirectly) affects the capital rights of this class must firstly have the consent of holders of at least 75% of the capital issued.

Company Financing

It is unfortunate that a large number of companies have tended to regard the issue of Preference capital as merely a step, towards higher gearing, which does not unduly ruffle the proprietors of the business. As a particular class of capital it has application to a special class of venture quite unrelated to gearing. Where a new development will require for its success limited use of fixed assets and the prospects for profitability seem assured but unspectacular as to growth the production of additional net profit for the Ordinary shareholders could well justify the issue of Preference capital. Should the venture be of limited life then the capital should likewise be limited as to the duration of its employment. Redeemable Preference shares could be used for financing such a project.

Defensively an associate company may be taken over. Additionally it may not be possible to effect any economies or to develop growth parallel to that enjoyed by the surviving corporation. Clearly the issue of the survivor's equity capital is unfair to the shareholders. In such a case the employment of Preference capital may be a fairer solution, provided the servicing of such capital is possible from the added net profits brought into account.

The cost of servicing this class of capital is a greater charge on profits than fixed interest borrowing. The shareholders' admission of this senior capital is compensated by the lesser restrictions imposed and by the fact that in conditions of extreme unprofitability they are somewhat better off during the period of recovery than would be the case if the capital were subject to more compulsory servicing. Where capital is redeemable it could well be that it will once again be found necessary for the borrower to provide a sinking fund. Whilst a Debenture sinking fund generally may not be reinvested in the company the share redemption reserve may be so employed. At present rates of tax the cost of annual servicing of a 7% Preference share is equivalent to that attributable to fixed interest borrowing at 12.2% p.a. Therefore directors, in seeking to employ Preference capital to finance expansion, must firstly equate the extra 5.2% p.a. servicing costs to the differences in restrictions which will be imposed. Additionally the permanence of Preference capital is often of value in financing a long term project.

In certain instances the alternative view may well have application. The cost of servicing this class of capital can be cheaper than that for equity capital raisings. Trust Deed limitations on the further raising of fixed interest capital may be such that an increase in shareholders' funds is a necessary prerequisite to further expansion. If this be the case the raising of shareholder' capital is to be coupled with the additional borrowed funds then available to the company. Servicing must relate to the total funds so raised and in this context the use of Preference capital may well be the cheaper and more beneficial method of expansion. A gearing multiplier of six appears in a number of Trust Deeds so that the true cost of servicing the fixed interest borrowings can be regarded as the actual cost of interest rate plus 1/7th of the "grossed up" dividend rate on the Preference capital.

A forward thinking company faced with a prospect of cheaper borrowing rates in the future may well order its capital expansion plans to take account of future expectations. If these plans involve shareholders' funds and a larger quantity of fixed interest borrowing it is clearly to its advantage to raise the larger sum when the servicing costs have reduced. Although the smaller sum may reduce the Ordinary shareholders' earning rate in the short term, it becomes justifiable if the maximization of profit in the long term is the goal.

As every privilege begets an obligation, so directors are required to be mindful of the position of both equity and Preference stock holders. Occasionally a director is appointed solely for this purpose. Because the voting rights for Preference shares are often only exercisable under certain conditions these shareholders are rarely wooed in a company takeover and in certain cases have suffered through neglect of their interests in the ensuing negotiations. There is strong argument for requiring redemption if, in a take-over or merger, the company is not the surviving corporation. An inherent weakness in this argument lies in the fact that it is the weaker company which is absorbed and it may not possess retained profits adequate for the exercise.

Investment Characteristics

In the assessment of the quality of a Preference share certain areas of analysis may be regarded as common basis requirements, whereas the degree of importance attached to others becomes a matter of individual judgment. It is sufficient to attempt to cover most of these features leaving to the individual the order of importance ascribable to each.

The basic requirements are to be found in the Articles of Association of the company, which will set out the description of the stock, the number which may be issued and the rights in respect of dividends, return of capital, voting and attendance at meetings. It is a wise precaution to ascertain if additional shares of the same class may be issued at a later date as well as examining under what conditions senior ranking shares may be offered.

Where the share is irredeemable the investor should give more than circumspect attention to the marketability of the stock purchased. Clearly if it has required some months to acquire a modest holding it should be recognised that the period of sale could be three times as great.

"Life Office Investment in Australia" — a report by Advanced Study Group No. 2, which was formed by the Life Discussion Group of the Insurance Institute of New South Wales, has listed four factors affecting marketability. These are:

(a) The number of shares in the public's hands and if supply and demand are not in reasonable balance the market could have little meaning. The present trend is for Preference shares to gravitate to institutional portfolios reducing the volume of trading in these shares.

(b) The withdrawal of a class of investor from the market, e.g., tax legislation has caused Superannuation Funds to withdraw as investors in Preference shares.

(c) There is no real objection to the purchase of shares above par provided that the possibility of redemption either by contractual arrangement, liquidation or takeover is remote. This possibility is ascertainable by examination of the rights and privileges accorded the shares (set out in the Company's Articles of Association), and the general appraisal of the Company's future.

(d) Since unlisted companies publish no readily available up-to-date information, and because of the difficulty in determining market value, the shares have limited marketability and it is desirable that they should be redeemable.

Although the yield on cost is the prime determinant there have been market situations where the cost price exceeds the price level of a redemption option which could shortly be exercised or may even be open to operation at the time of purchase. Currently a listed Preference stock sells for 20 cents above the price at which the right to redeem has now been available to the issuing company for the last five years. Should the company decide to exercise its option an investor would suffer an 8% capital loss.

The investor must be mindful always of the safety of the return **of** and **on** his capital invested. To this end the cover afforded the dividend payment and the ultimate return of par value capital must be the subject of close scrutiny.

It has more generally been accepted that the safety of the investor's dividend income is measured by the number of times the available net profit after tax is divisible by the annual dividend commitment. To avoid the anomalous situation of a lesser ranking share appearing to be more safely covered by profits than a senior share, the use of "priority percentages" or variations of this exercise has been chosen as the more meaningful method of arithmetic calculation. If one extends the principle to apply to all senior ranking charges against profits earned it becomes clear that the base level of calculation must be profit before tax interest and depreciation. Alternatively profits before tax and interest can be used if depreciation is to be regarded as akin to an operating expense provided for whether profits are earned or not. The employment of either form of the latter base for calculation has the advantage that recognition is given to the level of fixed interest borrowing and other senior liabilities. To enable a satisfactory comparison to be made between fixed commitments payable from profits before tax and those payable from profits after tax, the "grossing up" of the dividends effectively allows for taxation which is a variable commitment sandwiched between the two fixed charges to be compared. An unsatisfactory high level of senior liabilities can result in a deferment of dividend payments in times of reduced profitability. It is equally necessary, as for equities, to make some assessment of the future trend of net profits. The examination of historical results provides little more than visible reassurance of one's independent assessment of management ability. Whilst a rising cover for the fixed Preference dividend commitment is impressive, nonetheless the examination of gross earning rate trends is important in that the analyst receives warnings of any serious decline in profitability which in turn may affect the marketability of the Preference share. The market price movements will not move as dramatically in response to profit decline as an ordinary share price. A lengthier period of time for decision is therefore afforded the Preference shareholder.

Present methods for calculation of asset cover do not regard Preference capital in the same family as the senior fixed interest borrowings of the company. One can still see a Preference share asset backing quoted as $13 per share and first mortgage Debentures shown as having an asset cover of $545 per $100 Debenture. Clearly there is merit in employing the same procedure as has earlier been suggested for the calculation of income cover. An excellent dissertation on this subject appears in the abovementioned publication by the Insurance Institute of New South Wales.

The arithmetical exercises employed for redeemable Preference shares differ from those described above in one aspect only. Profit must cover not only the dividend but the provision to redemption reserve as well unless that reserve already exists. A regular contribution to this reserve is to be preferred. Provision of a redemption reserve should be regarded as a contractual obligation to the Preference shareholders. In such context anything less than equal annual additions to the redemption reserve is against the best interests of both classes of shareholders and leaves the way clear to a later abbrogation of the rights of one class of shareholder to the benefit of another. Where redemption is undertaken at a premium the asset cover should be determined not in respect of the capital only but in relation to that sum payable on redemption.

Investor's Interest

Apart from those interested in a steady income in perpetuity which, except in one case only, is not provided by any Debentures issued in Australia, the investor most interested in this class of capital would be those corporations subject to taxation and entitled to claim dividend income as rebatable income. Section 46 (2) of the Income Tax and Assessment Act specifies:

"Subject to this section, a shareholder, being a company that is a resident, is entitled to a rebate in its assessment in respect of income of the year of income of the amount obtained by applying the average rate of tax payable by the shareholder—

(a) if the shareholder is a private company in relation to the year of income, to the sum of—
  (i) one half of the part of any private company dividends that is included in its taxable income; and
  (ii) the part of any other dividends that is included in its taxable income; and

(b) if the shareholder is not a private company in relation to the year of income, to the part of any dividends that is included in its taxable income."

To such a corporation Preference dividend of 7% has the same net worth as fixed interest income at the rate of 12% (approximately). A superannuation fund which has observed the 30/20 Legislation pays no tax. It would only obtain ad-

NEW CAPITAL RAISED — LISTED COMPANIES

New Money Raised

Period Year ended June	Through Preference Shares $ million	% of Total	Through Ordinary Shares $ million	% of Total	Through Debentures, Reg. Notes, Loans & Deposits $ million	% of Total	TOTAL
1961	4.6	1.1	192.4	43.9	240.8	55.0	437.8
1962	1.6	0.5	150.8	42.9	199.2	56.6	351.6
1963	1.7	0.6	103.0	30.7	229.9	68.7	334.6
1964	3.7	1.3	123.1	42.6	162.2	56.1	289.0
1965	5.8	1.8	141.7	44.6	169.9	53.6	317.4
Quarter ended March, 1966	1.6*	2.8	27.9*	47.9	28.7	49.3	58.2

*Author's estimates.

Source: Commonwealth Bureau of Census and Statistics, Canberra, Australia.

NOTE: Woolworths Properties Limited are issuing $7.0 million 6½% Preference Shares to existing Preference shareholders registered on 19th May, 1966, to be subscribed (a) in full on application on 2nd August, 1966, or (b) 50c on application on 2nd August, 1966, and the balance of 50c per share on 2nd February, 1967.

vantage from investment in Preference shares provided the yield on cost exceeds that offering on fixed interest securities. The improvement in yield can be equated to the differing degrees of security between the Preference shares and fixed interest securities available.

Are there any features of Preference share investment which can be regarded of interest to individual investors? Given that security for Debentures or Notes is stronger and that currently yields from Preference shares are lower than rates offered on fixed interest securities there are two plus aspects for Preference shares.

(i) They are more readily marketable.
(ii) Purchase of smaller units of investment is possible.

Because fixed interest stocks are not always available the small fund has often been invested in one or two stocks. Should either or both investments prove to be unfortunate the small investors entire savings may be tragically depleted. Clearly a spread of investment is possible with Preference shares. In the event of pending misfortune for a particular company it is relatively easier to quit a Preference share holding than a Debenture holding of the same size. Diversification of a portfolio within a class of investment has been said to indicate the degree of uncertainty attaching to the investors choice of stock. The company failures of recent times suggest that diversification is essential in the fixed interest class also. But it is not always possible. However diversification of a wide degree is possible in a Preference share portfolio. In fact it is possible to grade stocks and to so ensure that only the better stocks are included.

Stock Grading

The rating function suggested can be written as

$$\frac{C}{L} \times I$$

where C represents the number of times the servicing of the Preference capital and all other senior ranking capital is covered by the past five year average of profits before tax and interest charges.

L. represents the ratio that Preference capital and senior ranking liabilities bear to total tangible assets as disclosed in the latest balance sheet.

I. is the ratio that profit before tax and interest charges in the latest year bears to the previous five year average.

A high value for this function indicated the relatively better chance a Preference shareholder has of receiving dividend income over the next twelve months and of preserving a strong position in respect of the par value of capital so invested.

Lack of balance sheet information in relation to overdraft interest charges and lease rentals do not seriously impair the results but, needless to say if such data were available, the calculations should incorporate these senior charges on earnings.

Subject to the amount of fixed interest liabilities incurred the values of C will range from 0 to 100 and in rare cases to higher values. Stocks issued by Woolworths Properties, Union Theatres and other companies whose profit figures are determined in relation to servicing requirements will have ratings out of phase with the intrinsic relative worth of the stock. Clearly a highly geared company will have a low service cover for Preference capital and the value of the rating function will differ little from the numerical value of cover as the inverse multiplier I/L will approximate unity. Conversely a high rating will apply to companies whose issued Preference capital is not junior to any great quantity of fixed interest liabilities.

An examination of the intermediate situations discloses that the presence of senior ranking liabilities of any great size will lower the rating of the stock even though the liabilities require no fixed interest payments. The values given to the variable L range from 0.1 to 1.0 so that the inverse multiplier ranges from 10 to unity. Rarely does one expect to find values of L approaching 0.9. However finance companies and banks must have high gearing and Preference shares of these companies should be examined as a homogeneous group.

Finally, the multiplier I is used to promote those stocks of companies with orderly management. The choice of past profit history is recognised for what it is worth—a convenient rule of thumb measurement of management ability. This attribute has no known measuring device probably because an assessment is required of management ability in the unknown territories of the future. The effect of this multiplier gives little more than token recognition of the differences between managements of two companies.

Employment of the gradient of profits over the five year period was found to be much too strong a multiplier, emphasising, as it did, rating values much beyond what was intended. The function C/L must be the prime component of the rating factor. In the absence of an index more significantly representing management calibre and potential, particularly the latter characteristic, it is preferred to employ a multiplier which does not take away from the rating factor the dominant influence of a company's present gearing and its ability to generate earnings within such framework.

Ratings work best when applied to members of a homogeneous group. One should not lose sight of this aspect when applying the factor described. Happily, application may extend to a wide range of companies under the industrial classification, for it was this class which was the greatest employer of Preference capital in the post war years.