REDEEMABLE PREFERENCE SHARE FINANCING

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In recent years, redeemable preference shares have emerged as a popular instrument of medium-term debt. This article examines this form of financing and identifies the associated benefits to borrowers and lenders. Legal considerations impacting upon redeemable preference share financing are also considered.

INTRODUCTION

Preference shares have traditionally been regarded as a form of equity funding. However redeemable preference shares have emerged in recent times as a popular instrument of medium term debt.

The most common type of preference shares currently issued as debt instruments are cumulative, redeemable preference shares. "Cumulative" refers to the dividend payments; if one dividend is missed they accumulate until paid. Cumulative preference shares rank ahead of ordinary shares in a winding up. Capital and accumulated interest on the preference shares are required to be repaid before any payments are made to ordinary shareholders. "Redeemable" refers to the fact that the shares have a fixed redemption date or dates.

BENEFITS TO BORROWERS

Redeemable preference share financing may appeal to corporate borrowers under certain circumstances:

- Gearing and Debenture Trust deed Considerations

  Borrowing through an issue of preference shares although in reality a form of debt financing is shown on the balance sheet as equity funds and, consequently, may be used to favourably impact a company's gearing ratios. Moreover obtaining "quasi" equity funding through preference shares may be favoured by the borrower in that control of the enterprise stays with present owners as no voting rights are normally awarded with the issue of preference shares.

- Equity Market Conditions

  Ordinary share capital may not be available because of depressed equity market conditions. In this situation, redeemable preference shares may be used to fund an enterprise until market conditions improve to allow more orthodox types of share capital to be raised.

- Tax Considerations

  Preference shares may be issued where, for example, due to accumulated losses, a company is not in a tax payable situation. Where the issuing company is not in a position to obtain a tax benefit from interest deductions, it may be cheaper to pay, for instance, 10 per cent per annum on preference capital rather than 16 per cent per annum on normal borrowings.

  It is important to note that dividends on redeemable preference shares are, of course, not deductible for income tax purposes in contrast to interest which are, in the usual case, deductible.

BENEFITS TO LENDERS

Australian lending institutions have increasingly been willing to use redeemable preference shares as a medium term (up to approx. seven years) debt financing instrument. Lenders financing by way of subscription to issues of redeemable preference shares usually derive a significantly higher after-tax return than that available on comparable conventional debt financing.

The higher return results from the fact that the dividend received by the lending institution is not taxable in its hands and consequently is attractive in comparison to interest income which is, of course, taxable. The dividend is not taxable because it is generally fully rebateable for income tax purposes. Moreover, as dividend income is a non-accruing revenue item for taxation purposes, lending by way of subscription to redeemable preference share issues

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may also allow the lending institution to defer its tax liabilities.

Redeemable preference share issues may be made on the basis of a fixed return or provide for floating rates of return, generally at a margin over Bank Bills or the prime AMBA rate. Dividend payments are generally provided for on a quarterly or semi-annual basis.

SECURITY ARRANGEMENTS

Security for a redeemable preference share issue (in transactions where lenders require credit support) may take one of a number of forms:

1. Parent Company Guarantees —

   Often the local subsidiary of a large multi-national will be in a non-tax paying position during its formative stages and redeemable preference share borrowing may be attractive to it. In such a situation, a parent company guarantee may be sufficient security where the parent is a substantial entity in its own right.

2. Standby Letters of Credit —

   Redeemable preference shares are often secured by means of a stand-by letter of credit issued by an international bank. Where such a stand-by letter of credit is opened in favour of the lender securing payment of dividends as well as the amount invested, the credit of the bank is naturally substituted for that of the actual borrower.

3. Buy-Back Arrangements —

   Some issues of preference shares are secured by means of a buy-back arrangement with parent companies, either local or overseas. Under such an agreement, the parent supports the borrowing of its related company by agreeing to buy back the preference shares from the lenders. The obligation to buy-back may be triggered by certain events of default including failure to declare dividends at the agreed coupon rate or the failure of the subsidiary to meet certain financial covenants.

4. Other Security Arrangements —

   Redeemable preference shares may be secured through a "put" option (an option whereby one person has to sell an asset to another person at a set price at some established point in time in the future). For example, where the borrower holds a valuable parcel of shares in another company, an institution like an insurance company may secure the borrowing by agreeing to buy the parcel of shares at a set price, in case of default by the borrower.

LEGAL CONSIDERATIONS

The provision of the Companies Code and the Income Tax Legislation are important considerations in this type of financing. The issuing company's Articles of Association may require amendment to allow such issues. Section 120 of the "National" Companies Code is also important as it governs redemption of such shares. It provides that redeemable preference shares shall not be redeemed except out of profits or out of the proceeds of a fresh issue of shares made for the purpose. Moreover, any premium payable on redemption must also be provided for out of profits or the share premium account.

It is important to note that a company financing through an issue of redeemable preference shares cannot itself provide security for the issue. This is because such security arrangements would usually contravene Section 129 of the Companies Code which prohibits a company from financing dealings (including the giving of a guarantee or the provision of security) in its own shares. In practice, this difficulty can be overcome with the creation of a special purpose borrowing vehicle which issues the shares and is guaranteed by its parent company which is the ultimate user of the funds but not the issuer of the shares.

As this form of financing is structured around the availability of the dividend rebate, lending institutions generally require taxation indemnities. The most common indemnities are in respect of,

(a) the continued availability of the dividend rebate, and
(b) a change in the company tax rate (as this would impact upon the lender's return).

Participation by a lending institution in this type of financing requires the lender to be an Australian resident taxpayer. The institution must moreover be in a tax-paying situation in order to take advantage of the tax rebate on dividend received. Consequently, the scope for utilisation of preference share financing is limited by the level of tax shelter made available by a prospective lender for this type of transaction. Other investment avenues such as rebateable bonds and particularly tax-based leveraged and equity leases compete with preference shares for the lending institutions' available tax shelter.

A special issue requiring consideration in relation to preference share financing is the tax status of payments received by a lender in case of default by the borrower. As noted above, the availability of the tax rebate on dividends is central to achievement of a satisfactory rate of return to the lender. Where the

borrower defaults and the lender has recourse to the party securing the financing e.g. a bank through a letter of credit, the characterisation of the payment of amounts outstanding to the lender is important for income tax purposes.

Insofar as the payment represents outstanding principal, the payment, or part thereof, is clearly capital and hence non-assessable in the hands of the lender. However, the part of the payment that is designed to compensate the lender for a missed dividend is more problematic.

It is clear that it does not represent a "dividend" and, consequently, will not be rebateable in the usual manner. If the amount is indeed taxed in the hands of the lender, the return achieved by the institution will be significantly reduced. In practice, the exposure, in this regard is likely to be limited to any one dividend payment period e.g. three or six months, whichever is applicable. This is because failure to make or, indeed, in many cases, failure to be in a legal position to declare the pre-specified dividend, would constitute an event of default enabling the lender to accelerate the repayment of any amount outstanding under the financing arrangement.

The status of the amount designed to compensate the lender for a missed dividend is not clear. However, it seems likely that given the overall "quasi-debt" nature of the transaction, the amount paid in lieu of the dividend may be treated by the Commissioner as a payment "in the nature of interest" which, as it does not technically comply with the dividend rebate provisions, may be treated as assessable in the hands of the lender.

A possible method of overcoming this difficulty would be to extend the security arrangements to encompass a payment designed to place the lender in a position substantially identical to that which it would have been in had default not occured e.g. by "grossing-up" any payment to compensate for any tax that might be payable.

It is necessary in this regard to be aware of the presence of Section 261 of the Income Tax Assessment Act which renders void any covenant or stipulation in a mortgage purporting to pass through any tax on the mortgagee to the mortgagor. The section will not generally be applicable to the usual security arrangements supporting a redeemable preference share issue except where a mortgage or other charge (the definition of "mortgage" in Section 261(5) is wide) is taken to support a guarantee or other arrangement.

Other mechanisms designed to create a profit in the borrowing vehicle to enable it to comply with its dividend obligations, including management fees, intra-group transfer pricing arrangements etc, may be available where the security is provided by another member of the group. However, such arrangements may attract the general anti-avoidance provisions of Part IVA of the Income Tax Assessment Act.

THE MARKET FOR REDEEMABLE PREFERENCE SHARE FINANCING

Over the recent years, a significant market for redeemable preference share financing has developed. Substantial issues of redeemable preference shares have been made or considered by major listed companies including Wormald, News Corporation, Adelaide Steamships, Repco and Ampol, as well as by subsidiaries of major listed companies such as Henry Jones and W.R. Carpenter.

In one recent case, a borrowing company which found itself unable to take advantage of the tax benefit of interest deductions due to a downturn in profitability, restructured its financing arrangements with the agreement of its financiers by substituting redeemable preference shares for existing conventional loan facilities. This enabled the borrower to achieve a significant reduction in after-tax borrowing costs.

Redeemable preference shares have also become a significant lending avenue for lending institutions such as the trading banks, finance companies and merchant banks. For the trading banks, a major consideration, at least, initially, appears to have been that subscription to such issues may not come under Reserve Bank lending constraints which are no longer applicable.

Issues are generally arranged and managed by merchant banks and stock brokers. Generally, because of the substantial amounts of funds raised through such issues, the financings are syndicated among a group of lending institutions, each of whom provides an agreed proportion of the total funds to be raised.

A substantial secondary market for redeemable preference shares does not currently exist. However, some buying and selling activity has emerged in recent times mainly as a result of some lenders re-assessing tax shelter availability and adjusting lending portfolios. The further development of this secondary market, with its implications for the possible re-liquification of lending portfolios, would add to the attractiveness, for lenders, of this form of financing.

Despite strong recent growth, redeemable preference share financing remains a specialised form of debt funding appropriate particularly in some situations and, as such, an important financing option requiring careful consideration by corporate treasurers.