PAG Report

ScotiaMcLeod Portfolio Advisory Group

February 24, 2014

The Myths and Realities of Rate Reset Preferred Shares

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Rate reset preferred shares which only originated in 2008, now contribute to more than half (54.3%) of the Canadian preferred share market. This sector of the market will likely continue to grow as the majority of the issuance over the past years has been in this type of preferred share. Therefore, as an investor it is important to have a strong understanding of this product and the benefits and risks associated with purchasing a rate reset preferred share.

Do rate reset preferred shares have a maturity date?

No.

What is current yield?

Current yield is calculated by dividing the annual dividend of the preferred share by its current price.

What is yield to reset?

This is the internal rate of return based on the current price of the security and assuming par value ($25) at the reset date.

What yield do I use to evaluate rate resets?

It is recommended to look at the lower yield between current yield and yield to reset for the most conservative return estimate.

Can I put this type of security back to company at reset date for cash?

This type of security has no retraction right for holders and investors that need cash will have to sell the security at prevailing market prices.

Does the company have the option to redeem the security and pay in common shares?

If the company announces the redemption of a security it can only be paid in cash.

Will the security get redeemed at first reset date?

Not necessarily! It is the company's decision to redeem or extend and will depend on:

1. Company's cost of funding (credit spread) at reset date
2. Funding needs of the company
3. Outstanding payment schedule
4. Capital structure (Tier 1 Capital ratio - banks)
5. Demand for preferred share products

What reset spread will likely be redeemed?

There is not a specific reset value which dictates if a security will be redeemed or extended as it is the individual company decision. In general, securities with a higher reset spread have a higher likelihood of being redeemed versus a security with a lower reset spread, given both securities are similar in credit quality.

Why would a company redeem a security?

A company would redeem its rate reset if they could re-issue at a cheaper dividend rate, there is regulatory pressure to redeem, or they no longer need the funding.

What happens at the reset date?

Either the security gets redeemed at $25 or the holder has the option of choosing between a fixed or floating rate dividend (majority of rate resets).

When will the company announce if they are redeeming or extending a rate reset?

The company has to give holders at least 30-day notice announcing if the company plans to redeem the security.

What will be the dividend rate be if a security is extended past the initial reset date?

If a rate reset gets extended the fixed dividend rate will be equal to 5-year Government of Canada bond yield + a predetermined spread while the floating rate dividend will be based on 90-Day T-bill rate + the same predetermined spread.

Who has the option of choosing between a fixed or floating rate dividend?

The holder of the security.

Will a floating rate preferred share always be created following the extension of a rate reset?

No. There are a minimum number of shares which must opt to convert into the floating rate series in order for the floating rate preferred share to be created.

Should an investor choose the fixed rate dividend or the floating rate dividend?

It depends. There is not a dividend option that will always outperform as the performance and demand for the fixed or floating rate option will depend on the current interest rate environment and the forecast for future rates. Choosing between a fixed and floating rate dividend will depend on the income needs of the investor as well as the investors' interest rate expectations.

If I am holding a floating rate preferred share can I switch back to the fixed rate dividend?

Yes. At each reset date, holders may opt to convert to the fixed rate dividend option or stay in the floating rate preferred share given there is enough shares outstanding for each security to stay outstanding.

If the company gets acquired will the security be redeemed at par?

During an acquisition, there is not a clause in the prospectus which dictates that the security will be redeemed at a particular value. Therefore, each situation will be different and based on the specific transaction. In the past, many preferred shares have changed names and/or credit ratings and remained outstanding following an acquisition. Additionally, there has been situations when the preferred share is redeemed based on a tender offer which investor must vote on.

Will the rate reset be trading at par at reset date?

Preferred shares trade on a yield basis and at the reset date the security will be trading at a yield based on current market conditions. If markets are expecting the security to be redeemed at the reset date, it will be trading close to par. However, if it is expected that the security will be extended the price will be below par at the reset date.

Will company ABC be able to refinance cheaper than x.xx%?

When ABC issues a preferred share the initial coupon rate is set at a spread over the benchmark (Government of Canada bond yield) - which indicates the credit spread of the company at that particular time. Credit spreads can narrow and widen depending on the company's financial standing as well as the credit environment. Therefore there is no guarantee that ABC will be able to refinance at a cheaper rate, as it will depend the status of the economy with respect to the economic cycle.

What is the average credit spread for preferred share issuers?

Gauging historical credit spreads is a difficult task, as rate resets are a new product (2008) and currently there are rate resets with reset spreads ranging from +1.00% → +5.00%. Credit spreads should be considered a moving target and will fluctuate based on the financial strength of the company and the environment.

Why is this rate reset trading under par?

Preferred shares should be valued based on a yield basis rather than price. The price of a security may be under par to reflect a yield which compares with its peers of similar duration and credit quality. The yield will also reflect the return that investors require for the risk of the product.

What are NVCC rate resets?

This type of rate reset will automatically be converted into a number of common shares based on a pre-determined calculation under certain circumstances: OSFI announces the Bank is about to stop being viable. This product will be eligible as Tier 1 Capital under Basel III regulations.

Why isn't the price of a rate reset preferred share following the price appreciation of the common equity?

Preferred shares and common shares prices are influenced by different factors. Common shares prices are influenced based on the valuation of the company and growth potential, while preferred shares trade on a yield basis relative to underlying benchmark and its peers. For example, a company may announce an increase in its dividend payout for common shares which will likely cause the price of the common shares to appreciate. The credit spread of the company may stay the same in this situation and therefore the price of the preferred shares would not necessarily move higher.

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