

# PAG Report

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ScotiaMcLeod Portfolio Advisory Group

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2015 Rate Resets – What to Expect?

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Unlike in 2013 when we saw a majority of the rate reset preferred shares being extended at their reset dates, 2014 has been a different story. With an overall average reset spread of +403 bp it was expected that most 2014 resets would be redeemed at their reset dates. Thus far in 2014, we have seen \$6.5 billion in rate reset redemptions with an expectation that we will see an additional \$2.1 billion in the second half of the year. Of the \$6.5 billion of redemptions already seen this year, the average reset spread for the rate resets was +413 bp. Credit spreads have narrowed significantly since the 2014 rate resets were issued in 2009 (when credit spreads were at their widest point following the financial crises). The narrowing of credit spreads has lowered the cost of financing for companies. It is important to note that the credit quality of the company plays a significant role on what is or is not expensive financing for a company. For instance, a +418 bp reset spread for Atlantic Power, which is rated Pfd-5 by DBRS and S&P, is actually cheap financing for the company and will likely be extended at its 2014 reset date.

**2014 Rate Reset Redemptions YTD**

Ticker	Mkt Cap	Reset Date	Reset Spread (bps)
PWF.PR.M	\$175,000,000	1/31/2014	320
TD.PR.A	\$250,000,000	1/31/2014	196
TD.PR.C	\$220,000,000	1/31/2014	274
NA.PR.O	\$60,650,000	2/15/2014	463
NA.PR.P	\$43,125,000	2/15/2014	479
RY.PR.N	\$225,000,000	2/24/2014	350
RY.PR.P	\$275,000,000	2/24/2014	419
RY.PR.R	\$350,000,000	2/24/2014	450
BMO.PR.N	\$150,000,000	2/25/2014	383
BNS.PR.T	\$325,000,000	4/28/2014	414
BNS.PR.X	\$275,000,000	4/28/2014	446
CM.PR.L	\$325,000,000	4/30/2014	437
CWB.PR.A	\$208,817,400	4/30/2014	438
TD.PR.E	\$300,000,000	4/30/2014	500
TD.PR.G	\$375,000,000	4/30/2014	447
BMO.PR.O	\$275,000,000	5/25/2014	458
CIU.PR.B	\$160,000,000	6/1/2014	481
MFC.PR.D	\$450,000,000	6/19/2014	456
CCS.PR.D	\$115,000,000	6/30/2014	521
HSB.PR.E	\$250,000,000	6/30/2014	485
SLF.PR.F	\$280,000,000	6/30/2014	379
CM.PR.K	\$300,000,000	7/31/2014	218
CM.PR.M	\$200,000,000	7/31/2014	433
TD.PR.I	\$275,000,000	7/31/2014	415
TD.PR.K	\$350,000,000	7/31/2014	433
<b>Total</b>	<b>\$6,212,592,400</b>		

**2014 Expected Redemptions**

Ticker	Mkt Cap	Reset Date	Reset Spread (bps)
RY.PR.T	\$275,000,000	8/24/2014	406
RY.PR.X	\$400,000,000	8/24/2014	442
MFC.PR.E	\$350,000,000	9/19/2014	323
DC.PR.B	\$130,000,000	9/30/2014	410
BPO.PR.L	\$250,000,000	9/30/2014	417
BAM.PR.P	\$300,000,000	9/30/2014	445
EQB.PR.A	\$50,000,000	9/30/2014	453
RY.PR.Y	\$325,000,000	11/24/2014	413
<b>Total</b>	<b>\$2,080,000,000</b>		

As we move into the latter half of the year, we anticipate further redemptions, of which the average reset spread would be +414 bp. However, moving past the November reset dates, we anticipate that the rate reset environment is going to take on a different tone with regards to the likelihood of redemptions.

**2014 Potential Extensions**

Ticker	Mkt Cap	Reset Date	Reset Spread (bps)
TCL.PR.D	\$100,000,000	10/15/2014	416
AZP.PR.B	\$100,000,000	12/31/2014	418
TRP.PR.A	\$550,000,000	12/31/2014	192
FFH.PR.C	\$250,000,000	12/31/2014	315

**Rate Reset Extensions**

Towards the end of 2009 credit spreads narrowed significantly, which allowed companies to issue with lower reset spreads. As the reset spread is tied to a company's cost of funding, the lower the reset spread the higher the likelihood of extension. The 2015 rate resets have an average reset spread of +215 bp and therefore the potential for the majority of the rate resets to be extended. As the likelihood of extension rises, the security will trade with a longer duration. The longer the duration of the security, the more price sensitive it becomes to changes in interest rates. Bank rate reset will trade differently than non-bank securities as there is an incentive for non-NVCC bank securities to be redeemed prior to 2022 due to Basel III requirements whereas non-bank rate reset can get extended indefinitely.

<b>Outstanding 2015 Rate Resets</b>					
<b>Ticker</b>	<b>Mkt Cap</b>	<b>Reset Spreads (bps)</b>	<b>Current Yield</b>	<b>Yield to Reset</b>	<b>Reset Date</b>
BMO.PR.P	\$400,000,000	241	5.22%	1.07%	2/25/2015
FFH.PR.E	\$200,000,000	216	5.94%	39.90%	3/31/2015
AIM.PR.A	\$172,500,000	375	6.31%	2.74%	3/31/2015
BNS.PR.Y	\$265,000,000	100	3.99%	8.59%	4/26/2015
BRF.PR.A	\$250,000,000	262	5.41%	9.19%	4/30/2015
FTS.PR.H	\$250,000,000	145	4.85%	21.23%	6/1/2015
SLF.PR.G	\$280,000,000	141	4.83%	16.25%	6/30/2015
TRP.PR.B	\$350,000,000	128	4.93%	27.84%	6/30/2015
EMA.PR.A	\$150,000,000	184	5.11%	20.15%	8/15/2015
FFH.PR.G	\$250,000,000	256	5.60%	15.23%	9/30/2015
ALA.PR.A	\$200,000,000	266	4.95%	4.40%	9/30/2015
NPI.PR.A	\$150,000,000	280	5.67%	12.52%	9/30/2015
GWO.PR.N	\$250,000,000	130	4.24%	14.64%	12/31/2015
FFH.PR.I	\$300,000,000	285	5.35%	10.20%	12/31/2015
CPX.PR.A	\$125,000,000	217	5.60%	19.26%	12/31/2015
<b>Total</b>	<b>\$3,592,500,000</b>				
	<b>Avg. Reset Spread</b>	<b>216</b>			

In April of 2013 when Bank of Nova Scotia extended the first rate-reset with a reset spread of +205 bp, rate resets with lower reset spreads dropped significantly in price driving yields higher. Due to the high probability of extension, the 2015 rate resets with lower reset spreads are unlikely to trade around their \$25.00 par value as the reset date approaches. Prior to the initial extension, investors had not paid much attention to the reset spread as many believed that most would be redeemed at their first reset date, which turned out not to be the case.

With the 2015 non-bank rate resets having quite low reset spreads these securities have been trading at a discount as there is a low probability that these securities will be redeemed by the company at their reset date. Based on current market conditions, the 2015 reset spreads are cheap financing for these companies. When valuing these securities it is important to look at the lowest yield between the current yield and the yield-to-reset. The yield to resets is not very indicative of the actual return that an investor would receive if they purchased the security today as the yield is based on the security being redeemed at par at the reset date. Additionally, the current yield value only states the yield until the reset date as the dividend rate will change.

We will take a look at **Great-West Lifeco (GWO.PR.N)** for an example:

Ticker	Price (07/25/2014)	Current Yield	Yield-to- Reset	Reset Spread (bps)	Reset Date
GWO.PR.N	\$21.35	4.27%	15.55%	130	12/31/2015

The yield-to-reset on GWO.PR.N is much higher than the current yield because it is not calculating cash flows beyond the December 31, 2015 reset date. Since the first rate reset extension in 2013, GWO.PR.N has been trading under \$25.00 as this security is expected to remain outstanding indefinitely. To see a more realistic yield-to-reset value, cash flows should be extended out to December 31, 2020. The drawback to extending the yield-to-reset prior to the reset date is that you do not know where 5-year Government of Canada (GoC) bond yields are going to be and hence would be making a guess at future dividend payments. In this example, we have shown two separate cash flows based on current 5-year GoC yield 1.46% and an estimated 2015 5-year GoC yield of 2.50%.

Cash Flows based on Current 5 Yr		
		3.6500%
	21.35	GWO.PR.N
7/31/2014		-21.3500
9/30/2014		\$0.2281
12/31/2014		\$0.2281
3/31/2015		\$0.2281
6/30/2015		\$0.2281
9/30/2015		\$0.2281
12/31/2015		\$0.2281
3/31/2016		\$0.1725
6/30/2016		\$0.1725
9/30/2016		\$0.1725
12/31/2016		\$0.1725
3/31/2017		\$0.1725
6/30/2017		\$0.1725
9/30/2017		\$0.1725
12/31/2017		\$0.1725
3/31/2018		\$0.1725
6/30/2018		\$0.1725
9/30/2018		\$0.1725
12/31/2018		\$0.1725
3/31/2019		\$0.1725
6/30/2019		\$0.1725
9/30/2019		\$0.1725
12/31/2019		\$0.1725
3/31/2020		\$0.1725
6/30/2020		\$0.1725
9/30/2020		\$0.1725
12/31/2020		\$25.1725
<b>YTC</b>		
<b>5.78%</b>		
<b>5 Yr GoC: 1.46%</b>		
<b>Yield-to-Reset: 5.78%</b>		
<b>Current Yield*: 3.23%</b>		

Cash Flow based on 2015 Est. 5 Yr		
		3.6500%
	21.35	GWO.PR.N
7/31/2014		-21.3500
9/30/2014		\$0.2281
12/31/2014		\$0.2281
3/31/2015		\$0.2281
6/30/2015		\$0.2281
9/30/2015		\$0.2281
12/31/2015		\$0.2281
3/31/2016		\$0.2375
6/30/2016		\$0.2375
9/30/2016		\$0.2375
12/31/2016		\$0.2375
3/31/2017		\$0.2375
6/30/2017		\$0.2375
9/30/2017		\$0.2375
12/31/2017		\$0.2375
3/31/2018		\$0.2375
6/30/2018		\$0.2375
9/30/2018		\$0.2375
12/31/2018		\$0.2375
3/31/2019		\$0.2375
6/30/2019		\$0.2375
9/30/2019		\$0.2375
12/31/2019		\$0.2375
3/31/2020		\$0.2375
6/30/2020		\$0.2375
9/30/2020		\$0.2375
12/31/2020		\$25.2375
<b>YTC</b>		
<b>6.62%</b>		
<b>5 Yr GoC: 2.50%</b>		
<b>Yield-to-Reset: 6.62%</b>		
<b>Current Yield*: 4.45%</b>		

\*Based on new dividend payment and current price

As seen in the example above the yield can vary quite a bit depending on the underlying benchmark rate. Although there is a limited amount of 2020 rate resets presently in the market, they will be the best comparable for the 2015 rate resets that are likely to get extended. Currently, there are only four 2020 rate resets in the preferred share market, and their yields are mentioned in the table below.

Current 2020 Rate Resets					
Ticker	Price (07/25/2014)	Current Yield	Yield-to-Reset	Reset Spread (bps)	Reset Date
BAM.PF.E	\$25.37	4.34%	4.17%	255	3/31/2020
EMA.PR.F	\$25.39	4.18%	4.05%	263	2/15/2020
ENB.PF.C	\$25.13	4.38%	4.46%	264	3/1/2020
ENB.PF.E	\$24.98	4.40%	4.41%	266	6/21/2020

By comparing the table above to the GWO.PR.N, it can be seen that the GWO.PR.N current yield (3.23-4.45%) is trading in line with the 2020 rate reset preferred shares, which are yielding in the range of 4.05%-4.40%. Although the 2020 rate reset market is currently limited in issuance, it will expand as the 2015 rate resets begin to roll out at their reset dates and there is always the potential for more 2020 issuance.

### **Floating Rate Option**

Looking ahead, we believe that there is going to be a shift in the overall make-up of the preferred share market as we move through 2015 and investors choose between a fixed or floating dividend. If the company decides to extend its rate reset then the investor has the option to choose between a fixed dividend based on 5 year Government of Canada bond yields plus a reset spread or a floating rate preferred share, which is reset quarterly against a GoC 90 day T-Bill plus a reset spread. At this time, floating rate preferred shares make-up a small percentage (5%) of the overall preferred share market, but it can be expected that the market size will grow in 2015 as rate resets get extended. Floating rate preferred shares move in line with interest rate, therefore they can be used as a hedge in a preferred share portfolio against rising short-term interest rates.

### **Conclusion**

As the rate reset environment changes from a vast majority of redemptions in 2014 to extensions in 2015, investors must learn how to appropriately value these securities. Over the next year, it is expected that the market make-up for preferred shares will change with a growing number of non-bank floating rate preferred shares being created from the reset extensions. The decision on whether or not to move into the floating rate preferred share at the reset date will depend heavily on where interest rates are at that time and projected to be in the future.

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