# PAG Report

ScotiaMcLeod Portfolio Advisory Group

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## Rate Reset Preferred Shares: The most frequently asked questions of 2015

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## Structure/Valuation of the rate reset product:

1. **What are the options for a holder at the reset date?**
    a. Convert into the floating rate series – new dividend rate will reset on a quarterly basis at the 90-day T-Bill + predetermined reset spread (non-taxable event)
    b. Remain in fixed rate series – new 5-year fixed dividend rate set at the 5-year GoC bond yield + reset spread (non-taxable event)
    c. Sell into market (taxable event)
2. **Can rate resets be reset over a negative 5-year Government of Canada bond yield?**

    Yes, if 5-year GoC bond yields are negative upon reset, the new dividend would be set at a spread over a negative base rate.
3. **Are rate resets a new hidden form of a perpetual security?**

    Rate resets are perpetual in nature. If a company chooses, they can leave the rate reset outstanding indefinitely and allow the dividends on the rate resets to change every 5-year at a predetermined spread.
4. **Are rate reset dividends in jeopardy of not being paid?**

    In order for a company to not pay the dividend on their preferred shares they would need to completely eliminate the dividend on the common share beforehand. In general, the fall in preferred share prices year-to-date has been fairly unrelated to the credit quality of the companies, but more highly correlated with the drop in underlying benchmark yields and the lower dividend income.
5. **Why is the dividend all of a sudden lower on some rate reset securities?**

    Rate resets that have been reset within the last year have had their dividends drop as much as 40% due to a significantly lower underlying 5-year GoC bond yield compared to when these securities were issued → 5-year GoC bond yield in 2010 ranged from 3.24% to 1.83%.

| Date | Ticker | Initial Dividend | New Dividend | Div % Change |
|---|---|---|---|---|
| 31-Mar-15 | FFH.PR.E | 4.75% | 2.91% | -38.74% |
| 31-Mar-15 | AIM.PR.A | 6.50% | 4.50% | -30.77% |
| 26-Apr-15 | BNS.PR.Y | 3.85% | 1.82% | -52.73% |
| 30-Apr-15 | BRF.PR.A | 5.25% | 3.36% | -36.10% |
| 1-Jun-15 | FTS.PR.H | 4.25% | 2.50% | -41.18% |
| 30-Jun-15 | SLF.PR.G | 4.35% | 2.275% | -47.70% |
| 30-Jun-15 | TRP.PR.B | 4.00% | 2.152% | -46.20% |
| 15-Aug-15 | EMA.PR.A | 4.40% | 2.56% | -41.93% |

6. **What underlying base rate is U$ rate reset preferred share dividends reset over?**

    Canadian companies that have USD denominated rate resets will have their new dividend rate set over the US 5-year Treasury yield or the US 90-day Treasury yield.

7. **What Government of Canada bond yields should be used to evaluate the different types of preferred shares?**
    - **a.** Fixed Perpetuals: prices should move <u>inversely</u> with moves in 30-year yields
    - **b.** Floating: prices should move <u>with</u> moves in 90-Day T-Bills
    - **c.** Rate Resets: prices should move <u>with</u> moves in 5-year yields.
8. **Which yield is more accurate: current yield or yield-to-reset?**

   Focusing on the yield-to-worst, the lower of current yield and yield-to-reset, is the most conservative approach. Each valuation has its limitations; current yield is solely the dividend divided by price, and is only a valid yield until the next reset date as the dividend rate will change. Yield-to-reset assumes that the holder receives $25 par value at the reset date, which will not necessarily be the case.

   In today's environment, the lowest yield is often the current yield and investors should be content achieving that return while also having the potential for a higher return if prices appreciate.
9. **What is the difference between a NVCC bank reset and a non-NVCC bank rate reset?**

   A Non-Viable Contingent Capital (NVCC) bank rate reset is the new type of bank rate reset which in certain scenarios (government capital injection, bank no longer considered a going concern) can be converted into common shares based on a decision by the regulator. The old type of bank (non-NVCC) preferred shares do not have this embedded trigger feature and will no longer count as Tier 1 Capital on the bank's balance sheet post January 2022 as per Basel III Regulations.
10. **Why would a bank redeem a non-NVCC bank rate reset with a reset spread of +100 bps?**

    Although the +100 bps spread may be attractive financing if left outstanding beyond January 2022 the security will no longer count as Tier 1 Capital on the bank's balance sheet – making it less attractive for the company to be paying dividends (after-tax dollars) with no Tier 1 Capital treatment. It could be left outstanding if the +100 bps spread is considered cheap financing from a debt perspective, which is unlikely in the current market environment.
11. **How should rate resets trade as they approach the reset date?**

    If the security is expected to be redeemed at the reset date it will likely be trading fairly close to its original $25 par value; however, if the security is not expected to be redeemed at the reset date it will trade at a price to reflect a yield inline with its peers. Preferred shares trade on a yield basis rather than price.
12. **Is it the expectation that the 2018-2020 rate resets get redeemed at their respective reset dates?**

    So much can change in any given period of time that it is difficult to know 3 to 5 years in advance of a reset date whether or not the security will be redeemed. If a company has multiple rate resets outstanding it is likely that the rate reset with the biggest reset spread will be redeemed first, but once again that will be dependent on the credit cycle at the various reset dates.
13. **If a rate reset is trading near $25 does this mean it is going to be redeemed at the reset date?**

    Preferred shares trade on a yield basis rather than price, as the various securities have different dividend rates, reset dates and reset spreads. Just because a security is trading at $25, it does not mean that it will be redeemed as it will only be redeemed if it is in the company's best interest to do so which is a function of credit, and financing levels at the reset date.

## Overall Preferred Share Market:

1. **Why don't companies issue retractable preferred shares anymore?**
From a company standpoint, retractable preferred shares are considered debt on the company's balance sheet from a rating agency point of view rather than the equity treatment given to rate reset and fixed perpetual preferred shares. From a capital structure perspective, increasing a company's debt level can affect various debt ratios. Retractable preferred share are not tax deductible (unlike interest payments) so the retractable preferred share cost of capital is unlikely to be competitive with debt.

2. **Who are the main investors in preferred shares?**
Retail investors comprise approximately 70% of the overall preferred share market, while the remaining 30% is held institutionally.

3. **What is the size of the rate reset market in relation to the overall preferred share market?**

| | Par Value (Millions) | % of Overall Mkt |
|---|---|---|
| **Retractable** | $1,205 | 2% |
| **Rate Reset** | $39,972 | 59% |
| **Fixed Perpetual** | $17,263 | 26% |
| **Floating** | $4,850 | 7% |
| **Fixed Floater** | $1,659 | 2% |
| **Split** | $2,589 | 4% |
| **Total** | **$67,541** | **100%** |

## Performance Year-to-Date:

1. **Is the drop in price of preferred shares related to deterioration in the credit quality of the companies?**
Overall, the significant decline in the rate reset market has not been attributable to credit deterioration but a re-pricing of the rate reset product due to the low underlying benchmark interest rate environment causing rate resets to have a lower dividend following the first reset date.

2. **Why are high quality (investment grade) rate resets down as much as 40% year-to-date?**
The rate reset product as a whole has fallen out of favor with investors which led to a substantial decline in the value of these preferred shares. At this time, investment grade credit companies are not at risk of being unable to pay their preferred share dividends, instead these securities have fallen due to the inherent risk that at their reset dates they may be reset with a lower dividend rather than being redeemed.

3. **What has to change in the market to see rate reset prices move higher?**
A number of factors including supply/demand, underlying interest rates, credit quality of company etc., will have an impact on the price at which the security trades at in the future. Prices on rate reset should appreciate from current levels if the underlying 5-year Government of Canada bond yield moves higher as future dividend income is calculated over this base level. Investor sentiment is also an important consideration as demand for the rate reset product remains weak given the price moves seen already this year. Overall, future pricing will also be dependent on economic data and rhetoric from the Bank of Canada regarding the outlook for the Canadian economy.

4. **When will I likely get my capital back?**

   Rate resets are perpetual in nature; therefore, companies could leave these securities outstanding indefinitely – capital will be returned to the holder if the company decides to redeem the security or the holder sells the security in the secondary market.

5. **Are institutional investors influencing the volatility in the preferred share market?**

   Both institutional and retail investors are increasing the volatility within the preferred share market as the ability to transact in large volumes is fairly difficult due to the illiquidity of the market causing advisors and institutional investors alike to move the market in order to complete a large trade. There have been instances when institutional program buying/selling have caused significant movements in the preferred share market as ETFs must buy or sell the underlying securities on a daily basis depending on net creations/redemptions.

6. **What has happened to the credit profile of Enbridge preferred shares over the last year?**

   Enbridge announced in early December of 2014 that they were looking to drop-down its Canadian pipeline assets to Enbridge Income Fund (EIF) and were increasing their common share dividend by 33% which sparked a reaction from the credit rating agencies (S&P and DBRS) as this movement moved Enbridge towards a holdco structure, it increased the company's payout ratio range to 75%-85% and moved the assets further away from the issuing company making them more heavily reliant on the cash-flows from EIF. By the end of August, both S&P and DBRS had downgraded Enbridge's preferred share credits to Pfd-2L and P-3H giving Enbridge a split rating of investment grade/non-investment grade.

## Outlook:

1. **What impact will a further cut by the Bank of Canada have on the rate reset market?**

   A further Bank of Canada rate cut will likely negatively impact rate resets due to the correlation with the movement lower in the underlying 5-year benchmark. At this time, the 5-year yield has not fully priced in another cut. If another cut did occur any security that has its dividend reset shortly afterwards would likely be the most heavily impacted as these securities will be reset above the lower 5-year yield.

2. **What will happen if interest rates remain at current levels?**

   If underlying interest rates remain at current levels the dividend income received on rate reset preferred shares should continue to offer investors attractive yields relative to other corporate fixed income products. Interest rate movements are only one factor that impacts the price of rate resets. The credit spread environment and supply/demand factors will also affect the price/yield of preferred shares.

3. **Why would rate resets perform well in a rising interest rate environment?**

   The reset feature inherent in the rate reset product will cause rate resets, unlike straight perpetual preferreds, to move in line with interest rates as the dividends on the rate resets have the ability to be reset at a higher dividend rate in a rising interest rate environment.

4. **Is tax loss selling going to cause further downside pressure in preferred shares towards the end of the year?**

   It is likely that tax loss selling season will once again lead to further downside pressure in the rate reset market as investors have significant losses on the preferred share component of their portfolios.

5. **Should I be selling rate resets and buying fixed straight perpetuals?**

   Fixed straight perpetuals will trade similarly to corporate 30-year bonds – prices will move inversely to changes in underlying interest rates. In 2013 when 30-year bond yields spiked 100 bps in a short-period of time, straight perpetuals fell anywhere between 12%-18% depending on their dividends – the higher the dividend the less price sensitive the security will be to changes in underlying interest rates. With the potential of 30-year yields moving higher, rate resets should perform better in a rising rate environment, so it is not advised to move into fixed perpetual securities unless your view is that 30 year interest rates will stay at current levels for a longer period of time.

6. **Is this the time to be buying the BMO Laddered ETF (ZPR)?**

   The BMO Laddered ETF (ZPR) tracks the performance of the S&P/TSX Preferred Laddered Index which is comprised solely of rate reset preferred shares. The problem with ZPR is that it has an equal weighting in each year of resets. Near-term resets (2016/17) will be more price sensitive to changes in underlying interest rates which has the ability to affect the performance of the ETF.

7. **What area of the preferred share market looks attractive?**

   Currently, high quality names (Pfd-2L and above) with longer-term reset dates that have sold-off along with the rest of the market offer investors an attractive yield. These securities allow at least 3-5 years for holders to collect the stated dividend income and also gives time for underlying interest rates to move higher which acts as a base rate for future dividends.

8. **What are the risks of buying rate resets that are trading at $10-$15?**

   The risk of buying securities at deep discounts ($10-$15) is that there is probably a good reason as to the cheap prices versus other preferred share securities. The depressed price is typically indicative of a weaker credit quality, a low reset spread or a shorter term to reset, which can lead to increased volatility and more potential downside in the current environment.

9. **Is it advised to buy full or half positions of rate resets based on current market conditions?**

   With the outlook that underlying interest rates may remain at current levels for the near-term, it is recommended to slowly accumulate positions rather than buy full positions. Tax loss selling has the potential to add further pressure to the rate reset market heading into year-end as investors crystallize losses, therefore, it is recommended waiting until year-end to accumulate full positions as the market may remain volatile in response to negative investor sentiment, illiquidity, new issuance, global developments and central bank rhetoric.

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