Module 3 Readings

3–2 Gaunt C, "Have your cake and eat it", Leverage, November 2002, pp 18–21.

PREFERENCE SHARES

Have your cake and eat it

Convertible preference shares can offer a stable fully franked dividend with significant capital protection as well as growth opportunities, writes **CLIVE GAUNT**

In recent years some well known Australian corporations have issued a range of innovative securities for the purpose of raising long-term capital. Prominent among these securities are convertible preference shares.

As a hybrid of debt and equity, they generally offer the issuing company the lower cost of capital associated with debt but without an increase in leverage.

To the investor, they offer a relatively stable income stream, a significant degree of capital protection along with some opportunity for capital appreciation.

Perhaps the best way to appreciate what convertible preference shares can offer investors is to take a close look at a current convertible preference share on issue. A good example is the Computershare Reset Preference Shares (CPUPA) issued by Computershare last year.

Computershare announced last November that it intended to strengthen its balance sheet by raising $100 million to take advantage of growth opportunities. In the short-term, the funds raised would be used to reduce debt.

In December, the company announced that the issue had been heavily over-subscribed and, as a result, an additional $50 million was raised above the $150 million already accrued through the issue of 1.5 million reset preference shares at $100 per share.

A PRIORITY TO DIVIDENDS AND A RETURN OF CAPITAL

The Computershare offer gave holders priority on dividend payment and on return of capital. That is, subject to there being sufficient profits out of which a dividend could legally be paid, preference shareholders received a fully franked 5.5 per cent dividend ($2.75 in May and November) before any dividend could be paid on ordinary shares. In addition, preference shareholders would rank ahead of ordinary shareholders in the return of capital, should the company be wound up. However, it would rank behind all other creditors of the company. Preference shareholders have no voting rights, other than the limited rights prescribed by the ASX preference share listing rules.

The first $2.75 dividend payment was made in May and will be repeated every six months up to and including November 2006. If the company is unable to pay a dividend, it will not be required to make up the missed dividend at a later date. That is, the dividends are non-cumulative. However, some protection is given to preference shareholders – if a preference dividend is missed, a dividend cannot be paid to ordinary shareholders until two further consecutive preference dividends have been paid.

CONVERTIBLE INTO ORDINARY SHARES

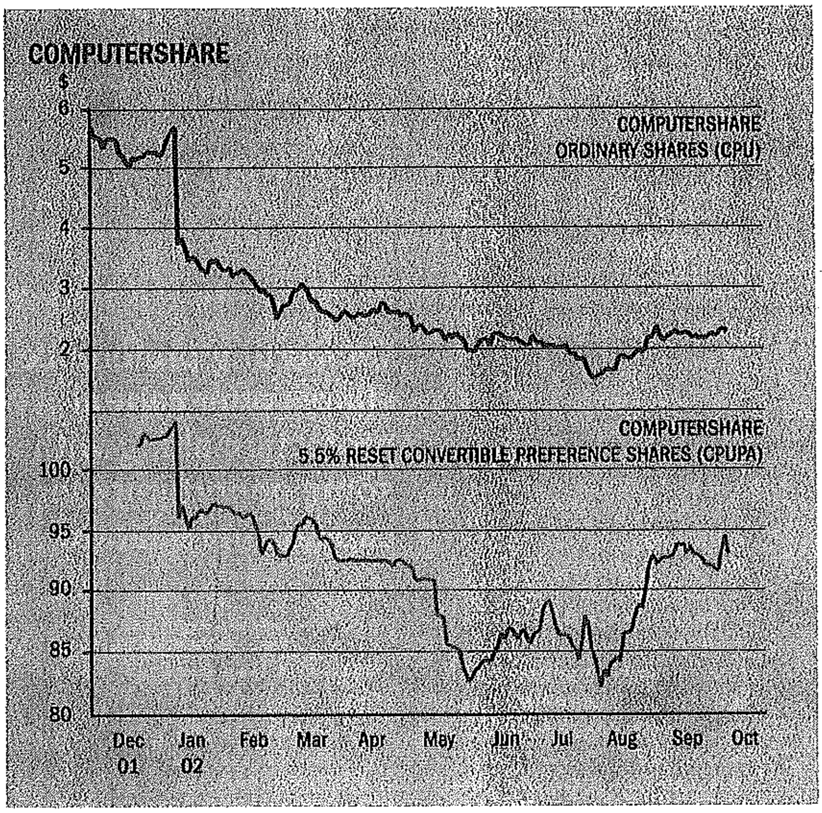
An important feature of convertible preference shares is the ability to convert them to ordinary shares. Both the shareholder and the company have the option of converting some or all of the preference shares to Computershare ordinary shares on the reset date. The first reset date is November 30, 2006, at which time the company will also announce the next reset date, though this can be no earlier than November 30, 2007.

Central to both the shareholder and the company's decision to convert are the conversion ratio and the conversion discount. The conversion ratio and discount determine how many ordinary shares are received in place of each preference share forfeited and this hinges largely on the market price of the ordinary shares at the reset (conversion) date. That is, each $100 preference share held entitles the holder to $100 worth of ordinary shares where the ordinary shares are priced at a 2.5 per cent discount to the market price.

For example, if the ordinary shares are trading for $2.05 then $100 will buy 50 ($100/[$2.05*97.5 per cent]) ordinary shares. Therefore, one preference share would convert to 50 ordinary shares.

However, the prospectus specifies a maximum of 100 and a minimum of 12.82 ordinary shares for each preference share converted. These limits provide the holder with the opportunity to share in some of the downside and the upside of movements in the ordinary share price.

VIRGINIA STAR



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CAPITAL STABLE WITH GROWTH OPPORTUNITIES

The $100 initial capital of the preference shareholder is protected as long as the ordinary share price finishes above $1.02 on November 30, 2006. To appreciate the value offered by this protection, consider what has happened to the Computershare ordinary share price since the preference shares were issued on December 18 last year. On that day, the ordinary shares closed at $5.20, and on September 13 this year they closed at $2.22. So, while ordinary shareholders have suffered a 57 per cent loss over the last nine months, the preference shares have lost just 7 per cent of their value. As long as the ordinary shares finish above $1.02 in four years' time, preference shareholders will achieve a 2.5 per cent capital gain and (assuming all dividends are paid) earn a 5.5 per cent annual dividend.

In the event that the ordinary shares finish below $1, preference shareholders will suffer a capital loss on the initial $100 invested. For example, if the ordinary shares finish at 50 cents, then preference shareholders will receive the maximum 100 ordinary shares worth a total of $50 in exchange for their $100 preference share. Therefore, preference shareholders will experience a capital loss equal to the percentage drop of the ordinary shares less than $1.

On the upside, preference shareholders will share in any appreciation in the ordinary share price should it finish above $8 at the reset date in 2006. For example, if the ordinary shares were to finish at $10, preference shareholders would receive the minimum 12.82 ordinary shares worth a total of $128.20 in exchange for their $100 preference share. Thus, preference shareholders will earn a capital gain equal to the percentage rise in the ordinary shares above $8.

IMPORTANCE OF PURCHASE PRICE

The overall return to the holder of the preference shares will also depend upon when they were bought and how much was paid for them. An investor who paid $100 for the preference shares when they were issued last year will earn about 6 per cent per annum (5.5 per cent per annum dividend plus a one-off 2.5 per cent discount on conversion) if they are held to the first reset date (Nov 2006) and if the ordinary shares finish between $1 and $8 on that date.

On the other hand, if the shares had been bought when they slumped as low as $82 (in August), the holder would earn a dividend yield of 6.7 per cent ($5.5/$82) plus around a 24 per cent capital gain over the life of the investment, as long as the ordinary shares close above $1 in November 2006. This translates to around a 12 per cent annual return, almost double that of the original preference shareholders.

FACTORS THAT INFLUENCE PRICE

While the market price of preference shares is clearly correlated with the market price of the underlying ordinary shares, there are other factors that can influence price. First are interest rates. A preference share is similar to a bond in that it pays a fixed amount of cash at regular intervals. In the case of a bond, the fixed payment is called interest or a coupon while the fixed payment from a preference share is called a dividend.

In the bond market, if interest rates rise the value of a bond falls as a purchaser demands a discount to buy a bond where the interest payment is fixed and can't rise as market rates rise. Similarly, the value of a preference share will fall with a rise in interest rates as the holders of the share are locked into the specified dividend payment. Ordinary shares will always fare better, as the ordinary dividend is free to rise as interest rates move up.

INVESTMENT AND TRADING OPPORTUNITIES

The second factor that influences the (mis)pricing of these preference shares is market neglect, which presents attractive investment and trading opportunities. That is, it appears from time to time that the market drives the price of the preference shares well above or below what fundamentals dictate. Consider the closing price of the Computershare ordinary shares on May 28, July 1 and August 29, which were all close to each other at $2.16, $2.19 and $2.18. Between these dates, the share price was volatile as the market grappled with new information about the company's future profitability. While the closing ordinary share price on these dates was similar, the supposedly less volatile preference shares closed at widely different amounts: $83.50, $86.60 and $92.80.

It is difficult to explain this as anything other than the result of the market mis-pricing the ordinary shares, the preference shares or both. In any case, investors who snapped up the preference shares when they were being dumped at the end of May have generated a healthy short-term profit and probably locked in an attractive four-year return.

WHO IT SUITS

Convertible preference shares will not suit everyone, but when properly understood they should have wide appeal. For conservative investors, they can offer a stable attractive fully franked dividend with significant capital protection and some opportunity for capital growth.

For traders and more aggressive investors, market neglect will sometimes offer these securities at prices that are likely to produce a healthy short-term profit or lock in a high return over an extended time.

However, investors should only take a position in these securities if they have a positive view on the prospects of the issuing company and only after they have read and fully understood the prospectus that outlines the often complex terms associated with their issue. ∎