

## Nordic Credit Rating's view on corporate preferred shares

### ANALYSTS

Sean Cotten  
+46735600337  
sean.cotten@nordiccreditrating.com

Mille O. Fjeldstad  
+4799038916  
mille.fjeldstad@nordiccreditrating.com

A number of Nordic corporations issue preferred shares as a part of their capital structure. Preferred shares diversify an issuer's capital structure and provide equity investors with predictable returns at the expense of the upside potential of common shares. In addition, preferred shares often confer voting rights, usually one-tenth of a vote, similar to B-shares. Despite features that are compatible with common equity, rating agencies tend to view preferred shares as weaker capital instruments when evaluating a company's capital structure. They often assess the equity content of preferred shares as lower than that of common equity and include a portion of the shares in their debt metrics and/or a portion of the prescribed dividend in their interest coverage metrics.

In this comment, Nordic Credit Rating (NCR) explains its own views on preferred shares when evaluating the financial risk of individual companies. NCR accepts that there is a role for preferred shares and capital instruments, such as corporate hybrid debt instruments and D-shares, in an issuer's capital structure to diversify the investor base, provide access to new capital and support senior creditors (see [Nordic Credit Rating's view on corporate hybrid securities](#), published 3 Oct. 2019). However, we tend to view capital structures that include preferred shares as somewhat weaker than those with only common equity, primarily because of investor expectations that dividend payments will be paid in all but the most significant periods of stress and given the presence of financial penalties for delaying dividends on preferred shares.

### INCENTIVES FOR CORPORATIONS TO ISSUE PREFERRED SHARES

The primary incentive for issuing preferred shares is that they provide access to additional investors while capping the amount of reported debt on the balance sheet. While preferred shares are reported as equity, the dividend payments on them are very similar to coupon payments on hybrid debt instruments. The yield on preferred shares is often higher than the average interest rate cost and makes preferred shares a relatively expensive form of financing. The cost to the company is exacerbated because dividends are made after-tax payments while debt payments are eligible for tax deductions.

Whether a company issues preferred shares, senior debt instruments, hybrid debt instruments, D-shares or common equity can also be affected by how rating agencies, investors and banks assess its debt levels and interest coverage. In an effort to reduce their overall financing costs, rated companies often consider which instrument gives them the best metrics based on the views of such third parties.

Another key incentive for the issuance of preferred shares is that they typically confer only 1/10th of the voting rights of common shares. For this reason, issuers and their owners are able to access equity without relinquishing control. This can be an especially attractive means of financing growth as common shareholders benefit most from a company's added prosperity.

### NORDIC CORPORATES' PREFERRED SHARES

We note that falling interest rates have increased investor interest in preferred shares as investors seek higher returns, while also contributing to increased asset values and growth opportunities for common equity holders. This has proven a particularly good trade for owners of real estate companies, which are more leveraged than typical corporations and, for this reason have benefited more from low interest rates and increasing real estate values over the past decade. This explains the high proportion of real estate companies among issuers of preferred shares in the Nordic region and particularly Sweden (see Figure 1). Our sample excludes some recent preferred share issuance by real estate developers which have been forced to defer dividends or offer distressed exchange options to investors when the high costs of financing proved unsustainable.

**Figure 1. Selected preferred share issuance by Swedish corporates, 30 Jun. 2020**

Company name	Industry	Yield*	Penalty interest	Market price (SEK)	Redemption price (SEK)	Liquidation price (SEK)
Aros Bostadsutveckling AB	Real estate	8.4%	10.0%	101.00	115 before Dec 2020 & 100 thereafter	115 before Dec 2020 & 100 thereafter
ALM Equity AB	Real estate	7.4%	5.0%	113.50	120	120
Amasten Fastighets AB	Real estate	5.7%	14.0%	348.00	350	300
Corem Property Group AB	Real estate	6.3%	7.0%	317.00	500	450
Fastpartner AB	Real estate	5.8%	8.0%	115.50	116.67	100
Genova Property Group AB	Real estate	8.1%	10.0%	129.00	130 before Nov 2025 & 110 thereafter	130 before Nov 2025 & 110 thereafter
Heimstaden AB	Real estate	5.4%	10.0%	367.00	375 before May 2025 & 330 thereafter	375 before May 2025 & 330 thereafter
K2A Knaust & Andersson Fastigheter AB	Real estate	6.3%	12.0%	317.00	350	287.50
Klövern AB	Real estate	6.5%	8.0%	306.50	500	400
NP3 Fastigheter AB	Real estate	6.6%	10.0%	30.40	35	30
AB Sagax	Real estate	5.7%	7.0%	34.90	35, or convertible to D-shares	30
Samhällsbyggnadsbolaget i Norden AB	Real estate	5.0%	10.0%	695.00	750 before Oct 2020, 650 before Oct 2024 & 600 thereafter	750 before Oct 2020, 650 before Oct 2024 & 600 thereafter
Footway Group AB	Consumer goods	6.7%	12.0%	120.00	105	105
Obducat AB	Technology	10.7%	n.a.	1.87	Conversion to common equity	n.a.
Sdiptech AB	Investment	6.7%	12.0%	118	105	n.a.

\*Contractual dividend/market value of preferred shares as at 30 Jun. 2020. n.a.—not applicable.

### NCR'S VIEWS ON PREFERRED SHARES

NCR believes that preferred shares can form a meaningful component of a company's capital structure. They provide issuers with equity-like flexibility at a lower cost of capital and increase investor diversity by attracting higher-risk investors with higher yields than senior bonds. Senior investors also benefit from more junior securities in the capital structure, increasing their own expected rate of recovery and potentially improving issue ratings on senior debt instruments. However, NCR is unlikely to see the issuance of preferred shares as a standalone driver of higher corporate issuer ratings.

Depending on the features of preferred shares, we can accord equity treatment of 0%, 50% or 100% in our calculations of the financial ratios used in our assessment of an issuer's financial risk. In particular, when preferred shares are treated as 50% equity or entirely as debt, they affect a company's NCR-adjusted net debt and interest costs. These two values are components in all the key metrics of corporates and real estate companies, and for this reason the equity treatment of a given issuer's preferred shares could affect the overall rating on the company.

When we consider the value of preferred shares in our adjustments, we use the liquidation value, regardless of the reported value of the shares on the balance sheet. In our view, this is the best representation of the issuer's ultimate commitment to its preferred shareholders. In an event of severe stress, in which dividends have been deferred, distressed exchange offers have been made and/or the market price of preferred shares indicates the potential for minimal recovery, we may adjust our view

on the value of the commitment to preferred shareholders or elect to change our equity treatment of a specific preferred share instrument.

In the interests of clarity and transparency, NCR plans to present a given issuer's credit metrics both with and without debt treatment in cases where debt treatment is accorded.

### PREFERRED SHARES VS COMMON EQUITY

As preferred shares occupy a place in the capital structure between senior debt and common equity, along with hybrid bonds and D-shares, NCR assesses how they compare with both equity and debt. The main characteristics of common equity are subordination, permanency and deferability. Below, we compare preferred shares and common equity on the basis of these characteristics.

Figure 2. Typical corporate capital structure

BALANCE SHEET SENIORITY	EXPECTED RISK	REQUIRED RETURN		
Bank debt	Low	Low		
Secured bonds	↓	↓		
Unsecured bonds				
Subordinated loans				
Hybrid securities:				
Hybrid bonds				
Preferred shares				
D-shares				
Common equity			High	High

#### Subordination

Preferred shares rank below non-deferrable subordinated loans in the balance sheet hierarchy (see Figure 2). Accordingly, they are senior only to common equity and D-shares. Typically, a D-share will have lower priority than preferred shares both in terms of payment of dividends and in a restructuring.

#### Permanency

Preferred shares are technically perpetual and therefore fulfil the requirement of permanency and rank pari passu with common equity. However, given the ability of issuers to redeem them at a contractual redemption price, preferred shares are in effect not permanent. Their permanency can be questioned further when redemption prices are reduced at stipulated future dates, increasing the likelihood of and incentive for redemption over time. This is the case for some of the issues listed in Figure 1 where both the redemption and liquidation prices fall on specific dates. We also note that preferred shares' documentation may carry clauses that allow conversion to D-shares or common equity.

#### Deferability of coupon and dividend payments

While dividends on common shares are inherently flexible, defined dividends on preferred shares are expected to be paid in most instances. When deferred, the dividend typically accrues, together with penalty interest, for future repayment. Further, deferral of preferred dividend payments could hinder an issuer's ability to issue new equity and prohibit dividend payments to holders of D-shares and common equity until preferred shareholders are paid in full, including interest. Accordingly, we believe that there are material incentives to avoid deferral of preferred dividends in most cases.

### NCR'S ASSESSMENT OF THE EQUITY TREATMENT OF PREFERRED SHARES

NCR can assign 0%, 50% or 100% equity treatment to preferred shares, based on the equity-like characteristics of a given instrument. Typically, instruments receive 50% equity treatment to reflect their shortcomings when compared with equity, in particular cumulative dividends with deferral penalties. In line with the previous section, the following explains how instrument characteristics affect our assessment of the equity treatment of preferred shares. As with shareholder loans, our views

of equity content and features of preferred shares are affected by the composition and nature of the ownership of the shares which can lead to 100% equity treatment of preferred shares despite some debt-like features.

**Subordination**

Preferred shares are subordinated to senior debt and non-deferrable subordinated debt instruments in a company's capital structure. As such, preferred shares provide a buffer for more senior debt, which we consider in our recovery analysis, when applicable, and could affect the issue rating(s) on more senior debt.

**Redemption and step-up features**

As described above, preferred shares carry early redemption rights based on contractual redemption prices. These prices effectively serve as a ceiling on the market price as issuers are incentivised to redeem shares when the market price exceeds the redemption price. We do not see redemption features in the same way that we see call features on hybrid debt instruments. However, in cases where an instrument's price falls at given future dates, increasing the likelihood and incentive for issuers to redeem over time, the permanency of the instrument comes into question.

While most preferred shares do not have the step-up features associated with hybrid debt, we would apply the same considerations to preferred shares as we do to hybrid debt instruments if they were to include increasing dividend payments. See [Nordic Credit Rating's view on corporate hybrid securities](#), published 3 Oct. 2019 for more information about the impact of call and step-up features on our view of hybrid debt instruments.

Individual instruments will always be evaluated on the nature of their actual permanency features.

**Deferability of dividend payments**

To receive equity treatment, an issuer of preferred shares must be able to defer dividend payments, with no time limit. Deferred dividends can be either cumulative or non-cumulative. However, we view penalty interest clauses and restrictions on dividend payments for common equity and D-shares as incentives to avoid preferred dividend deferral. When these clauses exist, we are likely to assign 50% equity treatment to preferred shares.

Should an issuer defer payments for a protracted period, we would assess the increasing liability and consider whether the company had liquidity issues or if it were selectively deferring dividend payments. This could affect the overall credit rating on an issuer. In the event of dividend deferrals, distressed exchange offers and/or when the market price of a preferred share indicates potential for minimal recovery, we may adjust our view on the equity treatment of a specific instrument.

**Figure 3. Equity content in hybrid securities**

	HYBRID LOANS	PREFERRED SHARES	D-SHARES
Equity treatment	0 – 50%	0 – 100%	100%

The individual assessment of equity treatment of all types of hybrid securities is discussed and decided in the rating committee based on the features of the issue and in the context of the issuer's capital structure. Should we consider the amount of hybrid securities as a proportion of total equity and liabilities to be very high, we could adjust the level of equity treatment to reflect this.

## DISCLAIMER

Disclaimer © 2020 Nordic Credit Rating AS (NCR, the agency). All rights reserved. All information and data used by NCR in its analytical activities come from sources the agency considers accurate and reliable. All material relating to NCR's analytical activities is provided on an "as is" basis. The agency does not conduct audits or similar warranty validations of any information used in its analytical activities and related material. NCR advises all users of its services to carry out individual assessments for their own specific use or purpose when using any information or material provided by the agency. Analytical material provided by NCR constitutes only an opinion on relative credit risk and does not address other forms of risk such as volatility or market risk and should not be considered to contain facts of any kind for the purpose of assessing an issuer's or an issue's historical, current or future performance. Analytical material provided by NCR may include certain forward-looking statements relating to the business, financial performance and results of an entity and/or the industry in which it operates. Forward-looking statements concern future circumstances and results and other statements that are not historical facts, sometimes identified by the words "believes", "expects", "predicts", "intends", "projects", "plans", "estimates", "aims", "foresees", "anticipates", "targets", and similar expressions. Forward-looking statements contained in any analytical material provided by NCR, including assumptions, opinions and views either of the agency or cited from third-party sources are solely opinions and forecasts which are subject to risk, uncertainty and other factors that could cause actual events to differ materially from anticipated events. NCR and its personnel and any related third parties provide no assurance that the assumptions underlying any statements in analytical material provided by the agency are free from error, nor are they liable to any party, either directly or indirectly, for any damages, losses or similar, arising from use of NCR's analytical material or the agency's analytical activities. No representation or warranty (express or implied) is made as to, and no reliance should be placed upon, any information, including projections, estimates, targets and opinions, contained in any analytical material provided by NCR, and no liability whatsoever is accepted as to any errors, omissions or misstatements contained in any analytical material provided by the agency. Users of analytical material provided by NCR are solely responsible for making their own assessment of the market and the market position of any relevant entity, conducting their own investigations and analysis, and forming their own view of the future performance of any relevant entity's business and current and future financial situation. NCR is independent of any third party, and any information and/or material resulting from the agency's analytical activities should not be considered as marketing or a recommendation to buy, sell, or hold any financial instruments or similar. Relating to NCR's analytical activities, historical development and past performance does not safeguard or guarantee any future results or outcome. All information herein is the sole property of NCR and is protected by copyright and applicable laws. The information herein, and any other information provided by NCR, may not be reproduced, copied, stored, sold, or distributed without NCR's written permission.

## NORDIC CREDIT RATING AS

[nordiccreditrating.com](http://nordiccreditrating.com)

### OSLO

Biskop Gunnerus' gate 14A  
0185 Oslo  
Norway

### STOCKHOLM

Engelbrektsgatan 9-11  
114 32, Stockholm  
Sweden