Evolution of the Canadian preferred share market

The Canadian preferred share market has traditionally been a popular vehicle of choice amongst retail investors over the years. Competitive compensation relative to traditional bond yields, better downside protection relative to common equities, priority of dividend payments and preferential tax treatment are some of the reasons for their enduring appeal. In addition, preferred shares are often easier to own than corporate bonds for retail investors by virtue of the fact that they are traded on exchanges. On the flip side, the preferred share market, much like the Canadian equity market, suffers from lack of sector diversity, is relatively illiquid, is deeply subordinate in the capital structure of an entity, and is effectively convertible to common, should the issuer face existential risk. After the relatively stable early part of the decade, the preferred share market declined in 2013 as interest rates rose. It then collapsed in 2015 following surprise rate cuts by the Bank of Canada, which damaged the rate-reset market as coupons started to get reset at much lower levels. As Canada's economic prospects improved and the bank embarked upon a hiking cycle, the preferred market has made an impressive comeback thanks to attractive valuations, higher five-year Canadian bond yields, normalizing credit risk premia and structural improvements.

Structural evolution

Generally speaking, preferred shares are issued in four formats: i) floating rate preferred share, where the dividend changes with either prime or Treasury bill rates on a monthly or quarterly basis; ii) retractable shares, which have fixed rates for life but provide the investor a put option to sell the securities back to the issuer at par at a predetermined date; iii) fixed-rate perpetual shares, which pay a fixed rate for the entire life of the security with no set maturity date; and iv) fixed-rate reset preferred shares, also called "Rate-resets", which pay a fixed dividend rate until the reset date. The latter two structures make up close to 85% of the market. Broadly speaking, having a view on the market can be likened to having a view on the fixed-rate reset structure, which represents over 60% of the total stock of preferred shares. The security is initially issued at a fixed rate for the first five years at a set spread over the prevailing Canadian five-year bond yield or 90-day Canadian T-bill yield. If the security is not called at the end of the term, it can be fixed or floated for another five years based on a reset spread over and above the Government of Canada five-year bond yield, which is also known as "Reset risk". Reset risk noticeably crept into the Canadian market when the Bank of Canada announced its two surprise cuts in 2015, driving the Government of Canada five-year benchmark yield to record lows, thereby incentivising many issuers to avoid a call. This action severely repriced the rate reset structures for another five years. Extension decisions generally depend on the prevailing interest rate environment, cost of capital and relative attractiveness of the reset spread. One must also be aware of the fact that it is the issuer who makes the call decision on these securities, so the investor can be exposed to reset risk if the economics of the call do not work for the company in question.

The legacy rate reset structure did not provide the intended protection, i.e., minimum coupon income should interest rates rally, simply because the Canadian bond market declined to generationally low levels of interest rates. The structures were issued at a time when reset spreads ranged anywhere from 100-200 basis points, which was too low to trigger the securities to be called given such low yields. However, to counter this problem, newer structures have been issued starting in 2015 that include a minimum dividend rate reset. If the preferred is extended at the reset date, the dividend rate cannot be reset lower than the initial dividend rate, i.e., the fixed dividend rate must be reset to the greater of the initial dividend rate and the Government of Canada five-year

yield plus a pre-determined spread. This newer structure has been popular amongst retail and institutional investors alike, which is more than adequately reflected in the valuation relative to other structures. The floor structures are exclusively issued by non-financial corporates as minimum rate resets have not been approved for financial issuers by the regulator, OSFI (Office of the Superintendent of Financial Institutions), at this time.

Market evolution

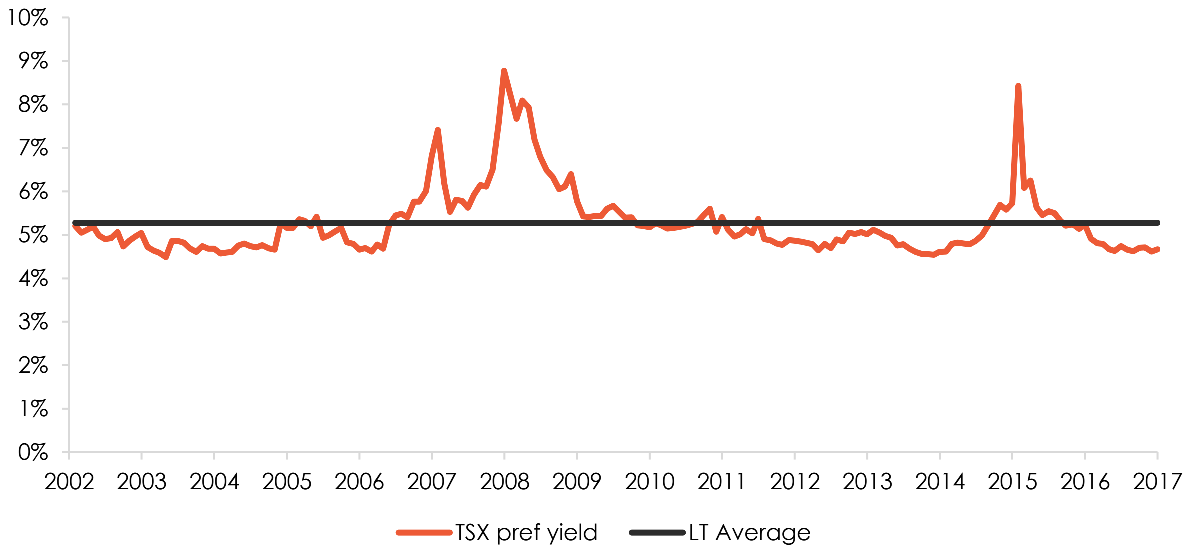
The Canadian preferred share market consists of approximately 360 issues from over 60 issuers representing a notional value of roughly $78 billion. This compares to the Canadian bond market, valued at approximately $1.6 trillion, the Canadian REIT market at close to $50 billion and the Canadian high yield market at $13 billion. The preferred market has been dominated by financial issuers, which represented over three quarters of all issuance about a decade ago. Over the last three years, financials have comprised close to two thirds of total issuance. As a result, financial issuers now represent a somewhat lower 63% of total Canadian preferred share market, as compared to 40% of the Canadian corporate bond market and 35% of the S&P/TSX Composite Index. The non-financial segment is dominated by pipelines and telecom, which are also prominent components of the Canadian equity and corporate bond markets. In terms of investor participation, Canadian retail investors used to represent close to 90% of the buyer base. That mix has skewed closer to half and half between retail and institutional investors in recent quarters, especially after the 2015 drawdown.

Performance review

Thanks to a healthy rebound in risk appetite, a strong Canadian economic recovery and a rise in bond yields, the preferred share market posted stellar gains in 2016 and YTD 2017. The Canadian preferred shares market has performed favourably relative to Canadian bonds (FTSE TMX Canada Universe Bond Index and FTSE TMX Canadian High Yield Index), as well as Canadian equities (S&P/TSX Composite Index). These returns do not take into account the dividend tax benefit that preferred shares enjoy in the Canadian market relative to other asset classes.

As of November 30, 2017, CAD	3 Months	YTD	1 Year	3 Years	5 Years	10 Years
Canadian preferred index	4.1%	13.6%	17.6%	1.0%	1.6%	3.3%
Canadian bonds	1.1%	2.9%	2.4%	2.9%	3.1%	4.8%
Canadian high yield bonds	2.4%	9.3%	11.1%	6.1%	6.0%	7.1%
Canadian equities	6.4%	7.8%	9.6%	6.0%	8.8%	4.7%

Source: AGF Investment Operations, Bloomberg, November 30, 2017.



Source: Bloomberg, November 30, 2017.

Despite recent outperformance, Canadian preferred shares have lagged other asset classes over the long term, as the table on the prior page shows. Notwithstanding a reasonable yield level of around 5%, the longer term total return profile of the asset class has been substandard, which speaks to the structural drawbacks that we highlighted earlier.

Canadian bank preferred share market

The Canadian preferred share market continues to be dominated by bank issuance. With the phasing in of modern bank regulation, the bank preferred market has undergone significant structural changes. As part of the revised regulatory framework, if a bank is deemed non-viable by the regulator in the hypothetical scenario of a major financial downturn, the regulator may contractually impose losses on the subordinated creditors, including preferred shareholders, at its sole discretion. After an updated Basel III definition of bank capital, legacy bank preferred shares (issued prior to 2012), as of January 2022, will no longer qualify to be included in a bank's stack of loss-absorbing capital. Starting 2013, all Canadian bank preferred securities include an explicit conversion trigger that allows OSFI to force conversion of preferred shares into common based on a pre-determined calculation in the event (i) the company has agreed to accept a capital injection by the government agency or (ii) the regulator deems the company has ceased or is about to cease to be viable and that, after conversion of all instruments, it is reasonably likely that the viability of the company will be restored or maintained. Further, these securities cannot have a minimum coupon floor and generally retain a rate reset structure with no step ups (higher coupons) allowed in the back end and no maturity date. To be clear, Canadian banks remain extremely healthy and expectations of such an event occurring in the foreseeable future are extremely remote, as reflected in the valuation levels of these securities. We firmly believe that investors should be cognizant of the contractual conversion triggers that the regulators have at their disposal before they invest in such securities.

Recent events

A large Canadian bank recently surprised the bank preferred share market by issuing an innovative structure called a perpetual Tier 1 NVCC (non-viable contingent capital) security in U.S. dollars that resembles Canadian bank preferred shares, to meet their capital needs. The structure ranks behind subordinated debt but ahead of

bank preferred share. Following the success of this capital raise in the U.S., further issuance by other banks may well occur, which may cause a significant decline in issuance needs in the Canadian bank preferred share market. Given the technical factors around potential reduced supply expectations, Canadian bank preferred shares reacted positively to the announcement. We believe that while the price action is warranted in the near term due to demand/supply imbalances, the longer term valuation implications are still highly uncertain for two reasons. First, as much as supply could be curtailed, this new structure has effectively subordinated all bank preferred shares almost instantaneously. It also brings about increased complexity in the bank's capital structure. Secondly, Canadian banks could issue this new structure domestically, which could reprice the domestic market wider in terms of spreads. All things being equal, the Canadian bank preferred market could be a more volatile asset class than what we have been used to in the past, given the more explicit relationship to common equity and the existence of fairly rich bank equity valuations at a time when Canadian household debt levels are high.

Summary

On one hand, the preferred share market today is structurally sound with better back-end reset spreads than used to be the case. On the other hand, there is lack of sector diversity, continued relative illiquidity and potentially more volatility due to new bank NVCC structures. While the dividend tax credit remains a valuable incentive to own preferred shares, potential investors in these structures should assess a number of inherent risks, including: structural subordination risk (relative to senior and subordinate debt), duration (interest rate) risk, issuer credit risk, rate reset risk and liquidity risk. From AGF's perspective, the rate reset market continues to offer reasonable value due to their higher back-end reset levels relative to history. We prefer non-financials to financials, due to existing minimum coupon floors providing downside protection as well as higher back end yields resulting in reduced extension risk. As far as banks are concerned, we currently do not believe that the new structures are compensating the investors for the inherent risk given their cost of equity. Looking at the market in aggregate, given where we are in the current rate environment and given our longer term return expectations with respect to traditional fixed income, preferred shares can deliver relatively reasonable longer term returns. Having said that, we anticipate that the market will be hard pressed to repeat 2016-17's stellar performance in 2018.

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