Financial Management

By:
Prativa Kothuru
Omkar Kadam
Yogesh Ghadge

Instruments: Preference Shares

1. Definition: Preference shares, also commonly known as preferred stock, are a special type of share where dividends are paid to shareholders prior to the issuance of common stock dividends.

Hence, preference shareholders hold preferential rights over common shareholders when it comes to sharing profits. Consequently, if a company lands into bankruptcy, preference shareholders are issued dividends first or have the first right to the company's assets before common stock investors.

2. Differences between Common Shares and Preference Shares:

Feature	Common Shares	Preference Shares
Ownership and Voting Rights	Have ownership and voting rights.	Usually do not have voting rights.
Dividends	Variable, not guaranteed, paid from profits.	Fixed, paid before common share dividends.
Profit Potential	Higher potential for capital appreciation.	Limited to fixed dividend returns.
Risk	Higher risk, paid last in liquidation.	Lower risk, higher claim in liquidation.
Priority	Lower priority in dividends and asset claims.	Higher priority in dividends and asset claims.
Stability	Less stable due to variable dividends.	More stable due to fixed dividends.

3. Features of Preference Shares:
Some key features of preference shares are:

1) **Dividend Priority**: Preference shareholders receive dividends before ordinary shareholders. These dividends are usually fixed and can be cumulative or non-cumulative.

2) **Asset Priority**: In the event of liquidation, preference shareholders have a higher claim on the company's assets than ordinary shareholders, though they rank below debt holders.

3) **Fixed Dividends**: Preference shares typically offer a fixed dividend rate, providing a predictable income stream for investors.

4) **No Voting Rights**: Generally, preference shareholders do not have voting rights in the company's decisions, unlike ordinary shareholders.

5) **Convertibility**: Some preference shares are convertible, allowing shareholders to convert them into a predetermined number of ordinary shares.

6) **Participating Preference Shares**: These shares allow shareholders to participate in the company's profits beyond the fixed dividend, sometimes sharing additional earnings with ordinary shareholders.

These features make preference shares a hybrid security with characteristics of both equity and debt.

4. Types of Preference Shares:

There are many types of preference shares prevalent in India. They are enumerated below-

1) **Cumulative Preference Share:**
Cumulative shares have a provision that allows investors to be paid dividends in arrears. It so happens that a company doesn’t have the financial capacity to pay dividends to its shareholders.

Unless dividends are not paid to preference shareholders, they cannot be paid to common shareholders. In such a scenario, the company decides to pay cumulative dividends in the next year.

Sometimes, interest earned by the shareholders on arrear dividends is also given to the cumulative preferred stockholders.

The calculation is as follows –

Quarterly Dividend = [Rate of dividend * Par Value] divided by 4

Cumulative dividends paid per share = Quarterly dividend * Total Number of payments missed

2) **Non-Cumulative Preference Shares:**
Non-cumulative preferred shareholders are eligible to be paid dividends only from a year’s profit.

So, a non-cumulative preferred stock does not issue unpaid dividends to the shareholders, nor can holders of such stock claim unpaid dividends in the future.

3) **Redeemable Preference Shares:**
In the case of redeemable shares, a company has the right to buy back the shares for its own use from shareholders at a fixed date or by giving prior notice after a period of time.

4) **Irredeemable Preference Shares:**
These shares can only be redeemed by the company at the time of liquidation or when the company winds up operations.

5) **Participating Preference Shares:**
Participating preference shares is where the company issuing the dividends pays increased dividends to the shareholders along with the preference dividend. This is done at a fixed rate.

Additionally, participating preference shareholders have rights on the surplus asset of the company at the time of its liquidation.

6) **Non-Participating Preference Shares:**
In the case of non-participating preference shares, the shareholders are entitled only to the dividends at a fixed rate and not to the surplus profit.

The extra profit is distributed among the common shareholders.

7) **Convertible Preference Shares:**
Shareholders of such shares have the option to convert the common shares to preferred shares. These shares are opted by investors who wish to receive preferred share dividends as well as want to benefit from an increase in the common shares.

So, the benefits are twofold- fixed returns by means of preferred dividends as well as the opportunity to earn higher returns as the common stock price increases. This conversion can happen within a certain period as per the prior agreement stated in the memorandum.

8) **Non-Convertible Preference Shares**
Shareholders of these shares do not hold the right to convert to the issuer's common shares.

9) **Preference Shares with a Callable Option:**
For shareholders having preference shares with a callable option, the issuing company holds the right to call in or buy back the stocks at a predetermined price after a set date.

The call price, the date post which the shares can be called and the call premium are mentioned in the prospectus.

10) **Adjustable-Rate Preference Shares**
For such shareholders, the dividend rate depends on the prevailing interest rates in the market and hence is not fixed.

5. Example:

Let's consider an example of Company A, which has issued preference shares and common shares to its shareholders.

- **Example Details**:
Preference Shares: 100 preference shareholders
Common Shares: 50 common shareholders

Preference Shares:
1. Dividend:
Fixed dividend rate: 5% per annum.
Face value of each preference share: $100.
Total preference shares: 100.
Annual dividend per preference share: $100 * 5% = $5.

2. Priority: In the event of liquidation, preference shareholders have a higher claim on assets and earnings than common shareholders.

Common Shares:
1. Dividend:
Dividends are variable and depend on the company's profits.
Assume the company decides to distribute $1,000 in dividends to common shareholders.
Total common shares: 50.
Dividend per common share: $1,000 / 50 = $20.

2. **Profit Potential:** Common shareholders benefit more from the company’s growth and profitability compared to preference shareholders.

Conclusion: Preference shareholders have fixed dividend rates whereas Common shareholders have variable dividends which are dependent on the company’s profits. Preference shareholders are given utmost priority in an event of liquidation or if company ever goes bankrupt. From the example, it is clear that Common shareholders benefit more compared to Preference shareholders but at a cost of risk. So, it might not be wrong to say that Common shareholders on one hand enjoys the profit of company whereas on the other hand Preference shareholders enjoys the cumulative dividend payouts even when company is not making profit (fixed dividends)