PREFERENCE SHARES

Preference shares refer to a form of shares that lie in between pure equity and debt. They have the characteristic of ownership rights while retaining the privilege of a consistent return on investment. The claims of these holders carry higher priority than that of ordinary shareholders but lower than that of debt holders. These are issued to the general public only after a public issue of ordinary shares.

A. Features of Preference Shares-:

Fixed Dividend Preference dividend is fixed and is expressed as a percentage of par value. Yet, it is not a legal obligation and failure to pay will not force bankruptcy. Preference capital is also called a *fixed income* security.

Convertibility Preference share capital may sometimes be convertible partly/fully into equity shares/debentures at a certain ratio during a specified period. A variant in India is cumulative convertible preference shares which combine the cumulative and convertibility features. It has, however, been a non-starter so far.

Voting Rights Preference capital ordinarily does not carry voting rights. It is, however, entitled to vote on every resolution if (i) the preference dividend is in arrears for two years in respect of cumulative preference shares or (ii) the preference dividend has not been paid for a period of two/more consecutive preceding years or for an aggregate period of three/more years in the preceding six years ending with the expiry of the immediately preceding financial year.

Participation Features Preference capital may be participating, entitling **participation** in surplus profits, if any, that is, profits after payment of preference dividend and equity dividend at a certain specified rate. Similarly, it may be entitled to participate in the residual assets after the payment of their normal claim according to a specific formula in the event of liquidation of the company.

B. Sources of Risk

No tangible benefit from company growth: Unlike ordinary shares, which might appreciate as company earnings rise, preferred shares generally offer a fixed dividend, meaning that any company growth has minimal effect on the preferred share price. If the company goes into a tailspin, however, that preferred stock dividend could be threatened, hurting its share price.

Tends to be issued by heavily leveraged companies: Among the most common issuers of preferreds are financial-services, telecom and utility companies, who use preferred stock as a tax-advantaged way to increase their borrowing power.

Call Risk : When companies issue callable preference shares, which afford them the right to repurchase shares at their discretion. This means that if callable shares are issued with a 6% dividend but interest rates fall to 4%, the company can purchase any outstanding shares(shares issued) at the market price and then reissue shares with a lower dividend rate, thereby reducing the cost of capital. Shareholders, however, would consider this a disadvantage.

Lack of Voting rights:since preference shares have no voting rights, the equity shareholders may not take into consideration the interest of preference shareholders.

C. Types of Preference Shares

I. Based on right to dividend :

1) Cumulative preference shares : Cumulative preference only have the right to get arrears of dividend. These shares get usual profits. The claim of profits on these shares accumulated when there no sufficient profits for the company. The arrears of profits will be paid in those years when the company makes sufficient profits. Preference shares are cumulative unless otherwise stated in the Articles of Association.

2) Non-cumulative preference shares : These shareholders have no claim for the arrears of dividend. These shares also get usual profits. The right of dividend on those shares cannot be carried forward to the next year. They will stand next to the cumulative preference shares and prior to ordinary shares.

II. Based on redeemability :

1) Redeemable preference shares : Redeemable preference shares are to be repaid after the completion of a specified period. Normally, the capital of the company is repaid only at the time of liquidation. However, the company can issue redeemable preference shares if the Articles of Association allow such issue. The company has a right to return redeemable preference share capital after a certain period. The Companies Act has provided certain restrictions on the return of this capital.

2) **Non- redeemable preference shares :** These shares which cannot be redeemed unless the company is liquidated are known as irredeemable preference shares.

III. Based on convertibility :

1) **Convertible preference shares :** Convertible preference shares can be converted into equity shares either partially or fully after the expiry of a specified period. The right of conversion must be authorised by Articles of Association.

2) **Non-convertible preference shares :** The shares which cannot be converted into equity shares are called as non-convertible preference shares.

IV. Based on right to participate in the surplus :

1) **Participating preference shares :** Participating preference shares have right to get share in the surplus profits along with the equity shares. The holders of these shares participate in the surplus profits of the company. They are paid a fixed rate of dividend and then reasonable rate of dividend is paid on equity shares. If some profits remain after paying both these dividends, then preference shareholders participate in the surplus profits.

2) **Non-participating preference shares :** Holders of these shares get a fixed rate of dividend. They do not carry the additional right of sharing the surplus profits.