



# PREFERENCE SHARES

## Rating Methodology

Preference shares are hybrid capital instruments with both debt and equity features. Preference shares are generally cumulative with respect to dividends, which requires all arrears to be paid to preference shareholders before the distribution of any dividend to the common shareholders. Moreover, preference shares are also typically non-voting to avoid preference shareholders' direct control over operations of the issuing firm.

Preference shareholders are ranked junior to debt because relative to debt holders, preference shareholders have limited legal recourse in the event of an omitted dividend and such omission does not automatically force the company into default. Conversely, as

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preference shareholders generally have a prior claim to both earnings and assets compared to ordinary shareholders, they rank above common equity holders.

For the issuer, preference shares' issue is advantageous be-

cause its non-recourse nature allows, in period of financial stress, a degree of payment flexibility that conventional debt instruments do not offer. In addition, non-convertible preference shares do not dilute equity holders' control or claim to higher dividends in case of enhanced future earnings. The main advantage for investors of preference shares is the priority over common shareholders in case of liquidation. Moreover, to account for the higher risk due to their subordination to all creditors, preference shares are generally issued at a higher after tax yield basis than debt.

Securities & Exchange Commission of Pakistan has recently allowed companies to issue different classes of shares after a period of more than thirty years. Taking advantage of this amendment, recently two companies from the leasing sector have diversified their capital base through issue of preference shares. JCR-VIS is of the opinion that the ratings of preference shares are important for highlighting the different risks associated with preference shares. Preference shares' junior position

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to debt and the inability of its holders to force bankruptcy in the event of a passed dividend creates various risks for the investor. First there is the risk of a disruption in the dividend stream. Second, in the event of a disruption, there is a risk that the issuer will not resume payments, or in case of cumulative preference shares, clear arrears. Even if arrears are cleared, there is the risk that they will be exchanged for additional, possibly illiquid securities. Finally, there is the risk of bankruptcy.

Ratings of preference shares measure the relative risk that the company will be able to make payments against dividends and principal redemption associated with specific preference share issues. The ratings reflect the probability that an issuer under stress may choose to forego or delay a prescribed dividend.

Dividend is considered passed or omitted if it was not declared either in the amount or in the period prescribed. Dividend impairment covers both scenarios: dividends passed and default. Default on preference shares occurs when:

1. The firm is forced into bankruptcy.
2. Contractual obligations (such as sinking fund payments or principal redemption) are not met.
3. Preference shareholders are forced to exchange the issue with one of lower economic value.

The financial analysis performed for preference shares rat-

ings is virtually the same as that used to rate debt. Fixed charge coverage and capitalization ratios are calculated treating preference share obligations as debt. A firm's ability to pay dividends depends in large part on its capacity to generate long run profits and on its earnings volatility. An inability to generate sufficient after tax profits or a great degree of volatility in earnings would increase the likelihood of distressed situations in which preference share dividends will be missed (passed).

Since the various liabilities of a company generally share the same probability of default, differences in their ratings are determined by their relative priority of claims. For successive layers of priorities, the ratings for the claims having the highest priority are determined and each subsequent layer of subordination is recognized with a corresponding lower rating. This criteria is applied throughout the corporate sector. However, taking into account the two rating perspectives i.e. timeliness and recovery potential, the degree of notching differs for investment grade and speculative grade companies. JCR-VIS places more emphasis on timeliness for investment grade ratings,

while for non-investment grade ratings, additional weight is given to recovery. Therefore, for investment grade companies, an issuer's senior unsecured debt is generally rated one notch lower than its secured debt and its subordinated debt one notch below its senior

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debt. Subsequently, the preference share is rated one notch below subordinated debt. However, for below investment grade issuers, notching for differences in priority of claim is often wider as the risk of default increases more rapidly as we go down the rating spectrum.

Furthermore, if there is a substantial amount of preference shares outstanding, its rating may vary greatly from the debt rating as the company has less capacity to pay dividends and debt service than debt alone. In fact, a large percentage of preference shares in

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down a company's debt rating. Even though a company under duress can stop paying the dividends on preference shares to avoid default, the burden of the preference shares increases the risk that the company will face such a financial crisis. The company will pay dividends as long as possible, which may greatly impair its financial strength or use funds that otherwise could be used to protect the firm's competitive position.

As an independent and unbiased third party opinion, the ratings may be used by market participants as a factor in the valuation of securities and the assessment of the risk of the particular issue. Ratings are not recommendations to buy and sell, but as an indicator of the issuer's ability to meet the terms of the issue, they are an important element in the preference shares investment decision.



**Faheem Ahmad**  
President & CEO, JCR-VIS  
Founder, VIS Group

Faheem Ahmad has diverse experience with international consulting agencies in USA & Middle East. He has also held senior positions with local industrial and financial groups. In 1994, he established Vi-

tal Information Services (Pvt.) Limited, which is a leading capital market research house. VIS has the largest data bank of corporate Pakistan. His major research work includes copy righted F&J financial strength rankings, Musharaka Variable Income Securities and stock market indices. VIS group includes JCR-VIS Credit Rating Company Limited and News-VIS Credit Information Services (Pvt.) Limited, the first private credit bureau of Pakistan. The majority of shareholders in group companies include the largest publication house in Pakistan and major financial institutions.

He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters degrees in Engineering and Business Administration from USA. His research work has been published in various international journals.



**Jamal Abbas Zaidi**  
Executive Vice President

Jamal Abbas Zaidi has more than three decades of rich experience in finance and general management, at local and international level. Prior to joining JCR-VIS, he was CEO of a leasing moda raba

and SEVP of the then largest leasing company having IFC and ADB equity. Internationally, he worked for World Bank at a multi-million dollar project in Nigeria. Mr. Zaidi has held key positions in the industrial and financial sector and has contributed many papers in international and local conferences and workshops. He is a member of rating committee of JCR-VIS. He is also Vice Chairman of Islamic International Rating Agency, Bahrain.

He is a fellow member of the Institute of Cost and Management Accountants of Pakistan.



**Kiran Lakhwani**  
Assistant Vice President

Kiran Lakhwani, CFA, currently leads ratings of leasing companies, industrial concerns and structured finance transactions. She is also involved in ratings of commercial banks and DFIs.

She holds a Masters degree in Business Administration from the Institute of Business Administration, Karachi.

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