CAIIB

Advanced Business & Financial Management

Module B : Chapter 7

Preference Capital

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What is Preference Capital?

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- Preference shareholders get a preference with respect to dividend as well as payment in case of liquidation.
- It is a quasi-risk capital because it is not as safe as secured debts which get payment priority over preference shares in case of liquidation of a company.
- If equity is a common stock, preference share is preferred stock.

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- Unlike equity capital, the dividend rate of preference share is fixed just like debentures.
- Generally, the dividend distribution is not obligatory like equity capital.
- Like equity capital, preference shares are paid dividend out of post-tax profits and hence the dividend on preference shares is not a tax-deductible expense.
- There are cumulative preference shares where the dividend is guaranteed.
- Redeemable Preference Shares are those which get repaid as per the terms of issue.
- As per the Companies Act 2013, companies limited by shares cannot issue irredeemable Preference Shares.
- All the preference shares must be redeemed within a period not exceeding 20 years. Redemption must be made out of profits or out of the proceeds of fresh share issue for such redemption purpose. However, in case of banks, perpetual debt instruments can be issued.
- Preference shareholders have a limited right to participate in voting as specified in the Companies Act, 2013.
- Where dividend on preference shares has not been paid for two years or more, such shareholders get a right to vote on all company resolutions.

Preference Capital

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- It is a good fund source for period up to 20 years.
- In case of infrastructure companies, the period can even be more than twenty years.
- Mostly such securities are privately placed and hence the cost of raising such funds is not high.
- There is no compulsion to pay dividend unless cumulative preference shares are issued.
- The recurring cost in the form of dividend is fixed and known beforehand.
- The current owners do not have to dilute their equity holding and hence they retain the present level of control over management.
- It is a part of the net worth of the company and hence it helps is improving the debt equity ratio.
- Absence of voting rights, unless the company skips dividend for two or more years, gives a comfort to the management who generally does not like interference.
- No security is provided to the preference shareholder unlike in case of debentures.

- Possibility of management interference in case of non-payment of dividends for more than two years.
- Dividend paid is a non-deductible expenditure which increases the real cost of funding.
- Redemption reserves are to be created leading to lower retained earnings which in turn may affect long term capital out lay plans to be funded out of internal accruals.
- Equity shareholders feel side-lined when the preference for dividend payout is given to preference shareholders.
- In case of liquidation, these shareholders get prior charge over the residual assets compared to the equity shareholders.
- Contingency of voting right devolution to these shareholders creates uncertainty and apprehension in the mind of the management.

Thank You

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