Preference Shares as a Source of Capital

by Ong Eu Jin and Christine Chan Ee Yin

Every company requires capital for growth. A company may raise capital through equity and/or debt. Preference shares, as a hybrid sharing attributes of both, can be a useful source of capital for companies.

The preference share is a share, by whatever name called, which does not entitle the holder to the right to vote on a resolution or to any right to participate beyond a specific amount in any distribution whether by way of dividend, or on redemption, in a winding-up, or otherwise.[1] A company may issue preference shares if it has been provided for in the company's constitution. The constitution must set out the rights of the preference shareholders in respect of repayment of capital, participation in surplus assets and profits, voting rights and priority of payment of dividends.[2]

Ownership and control

Voting rights are among the most significant tools in an investor's arsenal to safeguard his interest in the company. Ordinary shares are suitable for investors who wish to exert some control over the company, participate in the earnings and growth of the company in exchange for higher dividends.

Investors may subscribe for preference shares if they do not require voting rights in the company, but want the advantage of receiving fixed profits and are looking for a relatively more secure investment since preference shareholders are entitled to receive repayment of capital after creditors of the company in priority to ordinary shareholders.

As with debt financing, the issuance of preference shares does not lead to dilution in control of existing equity shareholders. This is because preference shareholders have no voting rights, except where it concerns:

(1) dividends in arrears;

(2) reduction in share capital of the company;

(3) any proposal affecting the rights attached to the preference shares;

(4) winding-up of the company;

(5) matters arising during the winding-up of the company; and

(6) disposal of the whole of the property, business and undertaking of the company.[3]

Unlike debt financing, however, the issuance of preference shares does not impose on the company the kind of undertakings, covenants and negative pledges, common in financing agreements with lenders. This reflects the fundamental difference between the company's relationship with lenders and investors. Issuance of preference shares would not, therefore, restrict the company's operating flexibility as might be the case for debt financing.

Payment of dividends

Debt financing is accompanied by the obligation on the part of the company to pay interest periodically. Such interest has to be paid whether or not the company makes profit. In a worst-case scenario, a default can ultimately lead to a compulsory winding-up of a company.

1 Companies Act 2016 [*Act 777*[, s 2
2 *Ibid*, s 90(4)
3 *Supra* n 1

However, preference shareholders are entitled not to interest but dividends, which can only be paid out from the profits of the company. During periods of financial hardship or little or no profits, dividends can be deferred if the preference shares issued are cumulative preference shares. Directors are not bound to recommend a declaration of dividends.

Where dividends are cumulative, the holder of preference shares can carry forward his entitlement to a distribution from one year to the next. Deferment of dividends is not a real practical concern as most companies will not defer dividends if they could possibly avoid the effect this would have on their reputation, as skipping of dividends would always create a dent on the image of the company. Deferment of dividends is not a ground to wind up the company.

Security

More often than not, lenders will require the creation of security over the assets of the company or in the form of guarantees by the directors or the parent company.

As a general rule, issuance of preference shares does not involve such obligation on the part of the company, its directors or its shareholders.

Debt-to-equity ratio

A company's debt-to-equity ratio is one of the most commonly used metrics to measure the financial status of a business. Companies that are too highly leveraged having large amounts of debt, compared to equity, often find it difficult to grow due to the high cost of servicing their debt obligations. A high debt-to-equity ratio is considered more risky by lenders and investors alike.

The issuance of preference shares will provide a company with a more favourable debt-to-equity ratio, enhancing its image as a well-managed business entity.

Costs

The interest expenses of debt financing are tax deductible as long as the monies borrowed are used to further the business of the company.

However, a company does not enjoy any such similar tax advantage with the issuance of preference shares as dividends paid on those shares are derived from after-tax profits.

Efficacy

It is less cumbersome to raise capital through debt as the decision to borrow requires only the resolution of the board of directors.

Issuance of preference shares requires the company to:

(1) amend the constitution of the company;

(2) procure the resolution of shareholders in a general meeting to authorise the board of directors to issue the shares; and

(3) pass the resolution of the board for the allotment and issue of the shares. **LH-AG**

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