Split Shares And The Credit Crunch

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I introduced split shares to readers in the November/December 2006 edition of *Canadian MoneySaver* [*CMS*]. This class of share is becoming increasingly important to preferred share investors since they are retractible – and retractible issues are becoming scarce.

As explained in the June 2006 edition of *CMS*, retractible issues have a definite end-date – as opposed to perpetuals, which have no stated maturity. The holder of a retractible issue can, at some point, demand that the company repay the invested money in cash, or with a better-than-equivalent number of common shares which makes the issues very bond-like, as explained in the *CMS* of February 2007.

Bond-like to a fault, in fact! The Canadian Institute of Chartered Accountants (CICA) changed the accounting rules (CICA handbook section on financial instruments – "Disclosure and Presentation") so that issuers may no longer claim that retractible preferreds are equity. They no longer improve the issuer's debt to equity ratio and are usually more expensive, so issuance by operating companies has slowed to a trickle – only issuers who have thoroughly sated the debt market's appetite for their bonds will take the plunge.

Split share corporations fill the demand. These corporations are similar to closed-end mutual funds, but instead of offering a single class of share providing an interest in the total return of the fund, they offer two. These two classes have a variety of names, but will be referred to throughout this article as "capital" and "preferred". The preferred shareholders get increased safety at the expense of expected return; the capital shareholders get an increased expected return at the expense of safety.

Split share corporations are often based on an underlying portfolio of financial issues, which are usually very liquid and pay relatively high dividends. The share price of the underlying financial issues gives protection to the split preferred purchaser by guaranteeing the principal amount invested, while the dividend, ideally, covers all the fees, expenses and distributions of the split share corporation.

These principles form the basis of all credit analysis, not just the credit analysis of split share preferreds. They may be formally stated as:

Asset Coverage - The number of dollars that would be available to cover each dollar of liability, after selling all the assets at fair value and after paying off all debts senior to the liability, but before paying any junior claims.

Income Coverage - The annual income available to cover each dollar of annual payments to the security holder, after paying all expenses and all annual amounts due to other security holders with a senior claim on the income.

The relative importance of these concepts is related to the nature of the asset. For example, income coverage is very important when investing in a mortgage bond of a large office building. If income falls short of requirements it will be relatively difficult for the building's owners to liquidate the property at a price that reflects the original asset value – or a price that reflects any given appraisal value, for that matter! Large office buildings might be fine investments, but liquidity (the ability to be converted quickly into cash at a predictable price) is not their strongest feature. Asset coverage is important for office building investments, but income coverage is more important.

Income coverage has less relative importance for split share corporations. If the dividends received are insufficient to meet commitments, the assets are extremely liquid. All the same, it should be remembered that all the fees, expenses and dividends paid by the corporation must be raised somehow. If the income is insufficient, asset coverage will decline as asset sales take place. In their less formal moments, the ratings agencies refer to these charges as a "grind" against assets and take account of this income shortfall when determining the chances of the corporation being able to keep all its promises, including the return of capital at maturity.

One element of the grind is the dividends paid on the capital shares. These dividends are junior to the dividends paid on the preferred shares and hence are not included when calculating income coverage, but are important nevertheless. When evaluating split preferreds, look for a restriction stating dividends on capital shares will not be paid if the asset coverage falls below a certain value. For example, the prospectus of the Financial 15 Corporation (available on their website at www.financial15.com) states: "No regular monthly dividends will be paid in any year on the Class A shares so long as any dividends on the preferred shares are then in arrears or so long as the net asset value per unit is equal to or less than $15.00 … Additionally, no special year-end dividends will be paid if after payment of such a special dividend the net asset value per unit … would be less than $25.00."

Provisions such as the above are valuable and give strength to the income coverage ratio.

Investors may also calculate the return on the underlying portfolio that must be met if the corporation is to meet all the investment objectives specified in the prospectus. Once this target is known, they may look at the portfolio and the manager's track record to come to a view on the probability of success.

Many split share corporations have a "covered call writing programme", often presented in fund documents as free money. If the corporation can receive $1 million in premia on written options, the promoters imply then that's exactly $1 million profit. But consider the following sequence:

- Stock is held with a value of $50.
- Manager writes a covered call at $55, receiving $1 as a premium.
- Stock goes up overnight to $70.
- Option exercised at $55.

The manager will take care to trumpet the $1 premium and the $5 realized capital gain, but it would have been better to have retained the stock and have an unrealized $20 gain! Without better disclosure of option-related portfolio activity than currently usual, I am unwilling to ascribe much reproducibility to option premia received and do not include them in "normal income" – only income that has a fair chance of continuation should be considered when calculating coverage ratios, not capital gains and other chancy things.

The financial issues on which many split share corporations are based have an unfortunate propensity for the occasional little accident. The credit crunch has savaged the value of financial issues and cause global financial institutions to cut their dividends. Asset and income coverage of split shares based on these stocks are declining, to the point where the Dominion Bond Rating Service (DBRS, www.dbrs.com) initiated an ongoing mass review of the sector resulting in many downgrades.

In preparing my survey, I examined the websites of the companies to determine their current NAV (net asset value), which some issuers report "per unit" while others report "per capital share", the latter value being the former after subtracting the par value of the preferred share. To find an issuer's website, go to the TSX website at www.tsx.com, get a quote for the issue of interest, then click the "Company Information" tab.

Table 1 summarizes the most important credit characteristics of each issue and an examination allows us to draw some conclusions but there are certain elements of DBRS' analysis – of any credit analysis – that should be kept in mind:

- Diversification is important! All else being equal, a split share with a portfolio comprised of a diversified portfolio is a better credit than one holding a single issue.
- Single issue split share corporations have a credit rating constrained by the nature of that single issue. The "BAM Split" issues (symbol BNA) are based on Brookfield Asset Management shares (BAM.A). This issuer's preferreds are rated Pfd-2(low). Any split share preferred based on the common is capped at this level since it is possible (not very

The Pick of PrefLetter

After the close on June 13, my monthly newsletter (www.prefletter.com) recommended SLF.PR.B, among others, for long-term, buy-and-hold investors.

Type of Preferred	SplitShare
Quotation (2008-6-13)	$19.93-09
DBRS Rating	Pfd-1(low)
S&P Rating	P-1(low)
Annual Dividend	$1.20
Yield-to-Worst Scenario	LimitMaturity
Yield-To-Worst	6.05%
Modified Duration, YTW	13.90
Pseudo-Convexity, YTW	1.01

SLF.PR.B - Redeemable at $26.00 commencing 2010-9-30; redemption price declines by $0.25 annually until 2014-9-30; redeemable at $25.00 thereafter. Next ex-date: 2008-8-16 (estimated). The Sun Life issues have been hit extremely hard in the recent market decline, despite the absence of any company specific news. Given their appearance of having been quite expensive in the year-to-date, I suspect that some large retail investors have been overweighting the issues and are now attempting to unwind their position. But that's just speculation.

The large discount to the redemption price means there is good potential for capital gains should long-term interest rates (which do not move in lockstep with short-term interest rates!) decline, while the risk of loss if long-term rates increase is no more than exists with an issue priced nearer to its par value (see "Perpetual Hockey Sticks", *CMS*, March/April 2007). Additionally, the issue carries a dividend of 6.05% (equivalent, for a taxable investor, to 8.47% in interest – see *CMS*, February 2007) and a high credit rating.

TABLE 1 - SOME SPLIT SHARE PREFERREDS AND THEIR CREDIT CHARACTERISTICS

Ticker	Annual Report Date	Reported Asset Coverage	Reported Income Coverage	Current Asset Coverage	DBRS Rating (at report date)	Current DBRS Rating if changed
ALB.PR.A	2008-2-28	1.8	1.6	1.8	Pfd-2(low)	Pfd-2(low) [Review Developing]
ASC.PR.A	2007-12-31	2.1	0.5	1.8	Pfd-2(high)	Pfd-2(low)
BMT.PR.A	2007-8-5	2.0	1.6	1.8	Pfd-2(low)	
BNA.PR.A / B / C	2007-9-30	4.0	1.1	3.6	Pfd-2(low)	
CBW.PR.A	2007-12-31	1.5	0.3	1.2	Pfd-2(low)	Pfd-3(low)
CIR.PR.A	2007-12-31	1.6	Negative	1.3	Pfd-2(low)	Pfd-3
DF.PR.A	2007-11-30	2.3	0.8	2.1	Pfd-2	
DFN.PR.A	2007-11-30	2.8	1.1	2.5	Pfd-2	
FBS.PR.B	2007-12-15	1.8	1.2	1.7	Pfd-2	Pfd-2 [Review Developing]
FFN.PR.A	2007-11-30	2.4	0.9	2.0	Pfd-2	Pfd-2(low)
FTN.PR.A	2007-11-30	2.6	1.0	2.2	Pfd-2	
FTU.PR.A	2007-11-30	1.9	0.4	1.4	Pfd-2	Pfd-3
GBA.PR.A	2007-12-31	1.6	0.4*	1.0	Pfd-2	Pfd-4(high)
LBS.PR.A	2007-12-31	2.3	1.0	2.2	Pfd-2	
LFE.PR.A	2007-11-30	2.7	0.5	2.4	Pfd-2(low)	
NBF.PR.A	2007-12-31	1.7	1.3*	1.7	Pfd-2(low)	Pfd-2(low) [Review Developing]
PIC.PR.A	2007-12-31	1.7	0.8	1.5	Pfd-2	Pfd-3(high)
RBS.PR.A	2007-5-31	2.0	1.3*	1.7	Pfd-2(low)	
SBC.PR.A	2007-12-31	2.3	1.3	2.2	Pfd-2	
SBN.PR.A	2007-12-31	2.3	0.8*	2.2	Pfd-2(low)	
TXT.PR.A	2007-12-31	1.7	0.4	1.6	Pfd-2(low)	Pfd-2(low) [Review Developing]
WFS.PR.A	2007-12-31	2.0	0.5	1.8	Pfd-2	Pfd-2 [Review Developing]

* Estimated by author

likely, but possible!) that the common could go to zero (wiping out the split share) while the issuer's preferreds could still be repaid. The issuer's preferreds cannot possibly be a worse credit than a split share based on that issuer's common, no matter how high the asset and income coverage.

That being said, the discernible trends are:

- Financial split shares that have invested internationally have been hit very hard so far in 2008. Canadian-based issues have been lucky – so far!
- DBRS appears to have tightened their requirements for a "Pfd-2" rating. A few years ago, asset coverage of about 1.4:1 was sufficient; it seems that the benchmark for this rating is now above 2.0:1.

So, that's what's happening in the world of split shares today. There are many issues available with some very attractive characteristics: a yield-to-worst (*CMS,* July 2006) that is very attractive to taxable investors when examined on an interest-equivalent basis (*CMS,* February 2007) and the increasingly scarce feature of a known maturity date. But first check the credit rating (*CMS,* October 2006) and check the issuer's website for current information before putting your money on the table.

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