SEPTEMBER 2020

Limited Recourse Capital Notes: a present for preferred share investors

Preferred shares, contrary to the other traditional fixed-income asset classes, are appealing for their upside potential in rising rate environments. But with the odds of the Bank of Canada hiking its benchmark rate in the short-term virtually null, the market isn't counting on rising benchmark rates to help drive preferred share returns in the near-term.

However, Christmas came early for preferred share investors when, on July 21, RBC issued Limited Recourse Capital Notes (LRCNs), a first-of-a-kind hybrid product that, while technically a debt security, count as Additional Tier-1 (AT-1) capital and will lead to important structural changes for the preferred share market over the coming years. Despite the market's prompt response and preferred share indices having gained about 6% since RBC's roadshow on July 15,[1] we believe that the asset class still provides an attractive opportunity for Canadian investors.

A game changer for the preferred share market

The preferred share market has rallied, as investors priced-in that all banks' preferred shares with reset spreads of 380 basis points or more will be redeemed.[2] Yet we believe the market is still not taking into account the full redemption story, which in our opinion will be supportive for the asset class for years to come.

The Office of Superintendent of Financial Institutions (OSFI)[3] confirmed that banks can issue up to 0.75% of their risk-weighted assets (i.e. 50% of their AT-1 capital) in the form of LRCNs. In dollars, this could represent more than $16.7 billion[4] of capital should the Big Six banks alone issue LRCNs up to the limit allowed by OSFI. We expect them to use most of the proceeds to redeem their more expensive preferred shares (i.e. those with resets greater than 380 basis points). All told, we expect that within the next two years, more than $7.8 billion of banks' preferred shares will be replaced in the market by LRCNs – representing more than 12% of the $65-billion preferred share market. Indeed, these redemptions are likely to create a scarcity effect from which preferred share investors will most likely benefit.

1 From RBC's roadshow on July 15, 2020 to July 31, 2020.
2 Source: Fiera Capital, as of July 31, 2020
3 OSFI regulates and supervises financial institutions such as banks and insurers operating in Canada
4 $16.7 billion includes RBC's $1.75 billion LRCNs issuance. "$" refers to Canadian dollars unless otherwise specified.

However, redemptions are likely to come from other sectors as well. Insurance companies, for instance, will most likely follow suit and issue LRCNs. Further, non-financial issuers will most likely amplify redemptions because they can access the hybrid bond market, which is currently a cheaper alternative than preferred shares. Altogether, for the next two years, we expect redemptions to total $11.05 billion (i.e. the aforementioned $7.8 billion, plus $0.9 billion from life insurers and $2.35 billion from non-financials) or 17% of the preferred share market. This transition will certainly be incremental, but this money will eventually return to investors' pockets, likely prompting them to frequently rebalance and redeploy capital in preferred shares over the coming years.

Importantly, as long as passive managers are not able to access LRCNs in their preferred share portfolios (as LRCNs are not included in the indices[6] which passive managers track), they will be forced to buy preferred shares regardless of the valuations, opening the door for active managers to be opportunistic. Moreover, since some active managers can hold LRCNs, they can take advantage of valuations difference with preferred shares to position their portfolios attractively.

Preferred shares with a spread of ~380 basis points or more are likely to be redeemed

RBC's LRCNs pay 4.5% interest
(a spread of 4.14% over the Canadian 5-year rate of 0.36%)

Equivalent spread for preferred shares of:
4.5% x (1-0.18) - 0.36% = 3.33%
Interest paid is tax-deductible, unlike dividend payments[5]

Issuers won't redeem their preferred shares if the financing cost versus LRCNs is equivalent (there are issuance and redemption fees). Hence, a buffer of 50 basis points and
a reset spread of ~380 basis points or more

Source: Fiera Capital, as of July 31, 2020

Potential redemptions in the coming years ($ Millions)

Sector / Structure	2020	2021	2022	TOTAL
Big 6 Banks / Non-NVCC Rate Reset	-	$1,899	-	$1,899
Big 6 Banks / NVCC Rate Reset + Big 4 Lifecos / Rate Reset	-	$5,250	$1,575	$6,825
Non-Financial / Rate Reset	$250	$1,335	$750	$2,335
Total	$250	$8,484	$2,325	$11,059
% of the Universe Market Value	0.4%	13.1%	3.6%	17.1%

Based on Fiera Capital's expectations as of July 31, 2020

5 Tax deductibility on interest payments for the issuer (not for dividend payments). We use the Big 6 Banks' average effective tax rate of 18% for the after-tax calculation.
6 The S&P/TSX Preferred Share Index and the Solactive Laddered Canadian Preferred Share Index

Which factors will drive future LRCN offerings' spreads?

LRCNs rank pari-passu with preferred shares, meaning that they are lower in the capital structure than senior bail-in bonds, subordinated debt, and banks' hybrid securities issued in the U.S. but higher than common equity. In terms of pricing, LRCNs also trade very similarly to rate-reset preferred shares, with the same factors – namely the Canadian 5-year rate and the credit tone – impacting spreads and expected returns. In fact, we view LRCNs as being similar to rate-reset preferred shares, though with added liquidity, and with interest payments rather than dividends.

While LRCNs are an overall cheaper funding alternative than preferred shares for the moment, it's important to analyze whether LRCNs will remain more advantageous from the issuer standpoint over a medium-term horizon. Admittedly, if risk appetite dissipates and credit spreads widen, investors would likely demand a higher spread compensation for future LRCNs, and issuers won't redeem as much preferred shares as highlighted in the previous section.

Our base case scenario is that government rates will stay range-bound in the near-term, and that the overall credit sentiment will remain positive. Regarding the former, the Bank of Canada and the Federal Reserve have anchored short-term yields lower to bolster the economy while buying issues along the yield curve to keep rates low for longer, which helps finance their governments' huge stimulus measures. For the latter, the support for credit products around the world is unprecedented from both governments and central banks, with the Federal Reserve pledging to buy up to US$750 billion of corporate bonds and exchange-traded funds made up of corporate bonds. The Bank of Canada's quantitative easing (QE) programs also now include a $10-billion Corporate Bond Purchase Program – and there's plenty of room left if needed, with only $139 million having been used so far.[7] The deluge of new fiscal and monetary stimulus programs, coupled with the global economy gradually reopening, helped Canadian corporate spreads tighten by more than 60 basis points since the peak of the COVID-19 crisis in March and will likely continue to be supportive for credit products.

RBC broke the ice and issued its LRCNs with a spread of 4.137% over the Canadian 5-year rate, but should credit sentiment keep improving and demand for LRCNs remain robust, it will be realistic to see issuers come to the market with a lower spread. Under this scenario – which is our base case – not only will preferred shares with high reset spreads (~380 basis points or more) be attractive for the issuer to redeem but so too will those with reset spreads around 300-375 basis points, increasing the rate at which redemption occurs and creating an even more pronounced scarcity effect.

WHAT LED TO LRCNs?

One might be surprised that OSFI allowed RBC to move forward with its proposal, in which LRCNs – a debt-financing instrument – are considered as AT-1 capital. We believe the reason OSFI accepted is twofold:

1

LRCNs represent an overall cheaper AT-1 funding alternative. Preferred shares have become very expensive to issue, as investors demanded higher spreads to compensate for lower benchmark rates. For example, based on our estimates, as of June 30, RBC would have had to print a preferred share with a reset spread of about 500 basis points over the Canadian 5-year rate, i.e. a dividend coupon yield of ~5.5%, to draw enough interest from investors – much higher than the 4.5% interest (or 3.7% after the tax deductibility for corporations[8]) paid by RBC on its LRCNs. It has been so expensive to issue new preferred shares that the last time a bank issued one in Canada was TD Bank and CIBC, both in May 2019.

2

LRCNs help banks diversify their AT-1 capital's investor base. In fact, LRCNs were made available only to institutional investors to align with the standards in Europe and in the U.S., where banks have been issuing their riskiest fixed-income paper to mainly institutional investors for years. Institutional investors have always shown only little interest for Canadian preferred shares, primarily due to the lack of liquidity. Thus, despite the fact that RBC's LRCNs yield less than preferred shares, its greater liquidity characteristics, coupled with its higher yield than traditional bonds, helped RBC find more than 100 institutional buyers.

7 As of July 31, 2020
8 Tax deductibility on interest payments for the issuer (not for dividend payments). We use the Big 6 Banks' average effective tax rate of 18% for the after-tax calculation.

An upbeat outlook for preferred shares

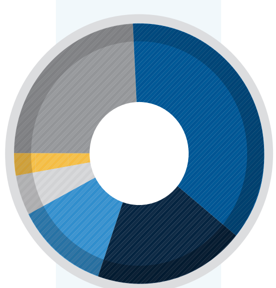
So far, we've seen that LRCNs are a game changer for preferred shares, but there are still other compelling reasons for Canadian investors to hold preferred shares, namely the issuers' high credit quality and the attractive yield.

Issuers' high credit quality

As it is the case for every other credit fixed-income product, the crux for investors is to evaluate the companies' ability to pay that income, especially during economic crises like the COVID-19 pandemic. Thus, priority number one is to assess a company's exposure to lower economic activity (for example, revenue losses, fixed costs and production disruptions) and its ability to weather any storm (liquidity levels, efficient capital structure, etc.).

As of the time of this writing, no Canadian preferred share issuers have cut their dividends, and we don't believe any of them are currently at risk of doing so. In fact, by our measures, more than three quarters of the S&P/TSX Preferred Share Index is composed of very high-quality companies that are well-equipped to cope with the current macroeconomic environment. Specifically, they are: the Big 6 Banks, which arguably constitute one of safest banking systems in the world; pipelines and utilities, which derive most of their revenue from regulated assets and long-term contracts; and telecoms and large life insurance companies, which have strong balance sheets and have been minimally impacted by the pandemic.

Allocation - S&P/TSX Preferred Share Index



Source: Fiera Capital via Bloomberg, as of July 31, 2020

Attractive yield

Despite the recent rally in preferred shares, investors are still very well-compensated to hold the asset class, with the S&P/TSX Preferred Share Index yielding 1.7% more than US High Yield bonds (after considering the tax advantage of dividend versus interest income for investors[9]) and an astonishing 5.3% more than Canadian corporate bonds as of July 31, 2020. To put this in perspective, investors can get a yield of 6.3% (after the tax advantage) by holding preferred shares of CIBC, which also trades at discount and could potentially be redeemed at par at the next reset date, or a yield of 4.3% by holding 2027 bonds of Ford Motor, an issuer that has been hurt by the pandemic and that has a BB+ rating and a negative outlook from S&P Ratings.[10]

Traditional fixed income index yields

	Pre-tax Yield	Equivalent yield with tax advantage
S&P/TSX Preferred Share Index	5.73%	7.16%
Solactive Canadian Laddered Preferred Share Index	5.99%	7.49%
FTSE Universe Bond Index	1.20%	1.20%
FTSE Corporate Universe Bond Index	1.87%	1.87%
FTSE Corporate BBB Universe Bond Index	2.35%	2.35%
BofA Merrill Lynch US High Yield Index	5.46%	5.46%

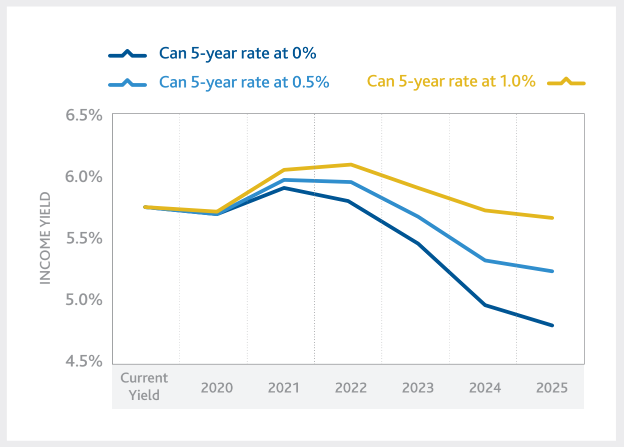
Source: Fiera Capital via Bloomberg, as of July 31, 2020

While preferred share yields are indeed compelling, investors may be concerned by their floating aspect – especially in the current low rate environment. About 77% of the index is composed of fixed-floating issues whose yields reset every 5 years with a fixed, pre-determined spread over the Canadian 5-year rate (another 1.2% is in floating rate issues). As fixed-floating issues reset at a lower rate than they did at their previous reset date, concerns that preferred shares' yields won't be as generous in the future are understandable.

9 We used 1.25x as an approximation based on the most recent Ontario fiscal treatment for dividend vs interest income for investors.
10 As of July 31, 2020

However, the impact of lower government rates on preferred shares' income yield is probably less significant than one might think. In fact, the Canadian 5-year rate was not much higher five years ago, hovering around 0.60% between 2015 and 2016, and even though 46% of the fixed-floating issues are resetting within the next two years, those issues will reset based on an only slightly lower 5-year government rate than their previous reset date. Moreover, the yield-to-call on the preferred shares that will most likely be redeemed is currently lower than the index's yield of 5.7%[11] – once these issues are redeemed (and out of the index), it will give a boost to the overall preferred shares' yield. Thus, if the Canadian 5-year rate stays at 0.5% and our redemption assumptions materialize, the index's yield would increase by 24 basis points by the end of 2021.

Income yield sensitivity of the S&P/TSX Preferred Share Index



Source: Fiera Capital via Bloomberg, as of July 31, 2020. Based on Fiera's internal assumptions on all preferred share structures, including extension/redemtion assumptions

The impact of lower government rates is admittedly more meaningful afterwards, with the index's income yield decreasing by 53 basis points after five years (all else being equal). That said, the income yield would remain above 5.2% (or 6.5% after the tax advantage), which still compares very favourably to the other traditional fixed-income asset classes. Moreover, a 5-year rate of about 0.5% forever is a very pessimistic scenario, as that assumes an extremely slow economic recovery from the current pandemic (or for another recession to happen in the near future).

We expect government rates to stay range-bound for the next 1 to 2 years, but as the economy recovers from the pandemic and as investors look past the large government deficits, rates should normalize higher, creating another significant, longer-term catalyst for potential capital gains.

Bottom line:
don't look a gift horse in the mouth

There is little doubt that LRCNs are a game changer for preferred share investors. New issuances among banks, life insurers and strong non-financial companies will decrease – potentially dramatically – for the next 2-3 years, but more importantly, we believe there will undoubtedly be a massive wave of redemptions, which has, in fact, already begun. These redemptions may trigger passive managers and other market participants to buy large quantities in a relatively illiquid market, which will be supportive for the preferred share market as a whole while allowing active managers to take advantage of the situation. Coupled with the high quality and the impressive yield of the preferred share market, we see bright days ahead for this often-overlooked asset class.

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