# Preference shares role in Indian Companies

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*Abstract*— **Ordinary shares, preference shares and debentures are three important securities used by the firms to raise funds to finance their activities. This study is an attempt to analyse the issues in the area of Preference Share Capital to find out its contribution in mobilising share capital in India. In discussing how the Preference Share Capital is used in India, this paper has been divided into six parts. In the first part Introduction, Second part Review of literature, Third part Sources of data, Fourth part theoretical aspects of share capital in accordance with Companies Act, 2013, and in the Fifth part, how the corporate firms are using Preference share capital in India by considering top BSE listed companies and the last part conclusion. It is found that In spite of some changes in companies Act 2013, there is no significant changes in use of preference capital by Indian corporate firms.**

***Keywords- Equity shares, preference shares , bonus shares, buy backs of shares, Redemption ,BSE,SEBI***

## I. Introduction

Ordinary shares, preference shares and debentures are three important securities used by the firms to raise funds to finance their activities. Ordinary shares provide ownership rights to ordinary shareholders. They are the legal owners of the company. As a result, they have residual claims on income and assets of the company. They have the right to elect the board of directors and maintain their proportionate ownership in the company, called the pre-emptive right[1].Preference capital represents a hybrid form of financing. It partakes some characteristics of equity and some attributes of debentures. Akin to promissory notes, Debentures are instruments for raising long term debt. Debentures often provide more flexibility than term loans with respect to maturity, interest rate, security, repayment, and special features. The advantages of debt financing are that interest on debt is tax-deductible expense and debt does not result in dilution of control. The disadvantages of debt are that it entails fixed interest and repayment obligations, it can cause financial distress, and it imposes restrictions that can impair the borrowing firm's operating flexibility[2]. As a class, debentures are less risky than preference shares. Preference shares, in turn , are less risky than common stocks[3]. One more alternative is Portion of the profits which is not distributed but is retained and reinvested in the business is known as retained earnings [4]. This paper concentrates on Preference share capital role in Indian companies.

## II. Review of Literature

In the light of the literature , some of the theoretical ideas and the corresponding empirical implications, and some empirical studies on Preference Shares role in the Indian Companies presented. Y. Subrahmanyam(1977) , in his study discussed, against the background of the nature and limitations of preference shares, the reasons why the role of preference shares as a source of long-term capital has been relatively insignificant in recent years, and tries to examine whether the same factors will limit their use in future[5] . According to L. C. Gupta. L.C.(1959), the purpose of this note is to present the results of an enquiry into the pattern of ownership of industrial shares in india[6]. Ashok kumar Panigrahi(2010) observed that Indian companies prioritize their sources of financing (from internal financing to equity) according to the law of least effort, or of least resistance, preferring to raise equity as a financing means "of last resort." Hence internal funds are used first, and when that is depleted debt is issued, and when it is not sensible to issue any more debt, equity is issued[7]. The hybrid securities is the least popular source of finance amongst corporate india. They are more likely to be used by low growth firms. Preference shares are used more by public sectors units and low growth corporates[8]

## III. Source of the Data

For our study purpose, only secondary data is used which is sourced from the website *www.moneycontrol.com.* The information relating to annual financial statements of sample companies for the period 2009-2010 to 2013-2014 have been obtained from the same. In some cases we have also collected the required information directly from the sampled company. Information relating to industrial and corporate growth and mobilization of corporate finance has been collected from various books, periodicals, government reports , other websites which are related to companies act and RBI Bulletins.

## IV. Share Capital in Accordance with Companies Act, 2013

The Government of India has notified Companies Act, 2013 (CA 2013) , which shall replace the erstwhile Companies Act, 1956 (CA 1956) . Under Companies Act, 2013 both private companies and public companies can have share capital of Two kinds only: (A) Equity shares with voting

rights, (B)equity shares with differential rights as to dividend, voting or otherwise and (C) preference shares.

A. *Equity shares with voting rights:*

Share capital which is not preference share capital is regarded as equity share capital(Section 85 of the CA 1956). There is no change in Equity shares with voting rights in CA 2013 also. Preference shares convertible at a later date into equity shares are known as convertible preference shares. Preference shares which do not carry any conversion option are known as non-convertible preference shares.

B. *Equity shares with differential rights as to dividend, voting or otherwise:*

Under Companies Act 1956, only public companies were required to comply with the rules when issuing equity shares with differential voting rights or dividend. However, under the Companies Act 2013, when either private companies or public companies issue equity shares with differential rights, they are required to certain conditions. The Companies (Share Capital and Debentures) Rules, 2014 prescribes several conditions for a company to issue equity shares with differential voting rights, such as (i)Share with differential rights shall not exceed 26% (twenty six per cent) of the total post issue paid up equity share capital, including equity shares with differential rights issued at any point of time;(ii)The company shall have a consistent track record of distributable profits for the last 3 (three) years; (iii)The company should not have defaulted in filing financial statements and annual returns for the preceding 3 (three) financial years.

Any offer of securities or invitation to subscribe to securities to 200 persons or less (excluding qualified institutional buyers and employees) in a financial year is a private placement under section 42(2) of the CA 2013. A reading of sections 42 and 62 of CA 2013 read along with the corresponding rules issued there under suggests that a 'private placement' and 'preferential allotment' under sections 42 and 62, respectively are one and the same and they must both comply with the same provisions and procedures. An offer of securities made to the existing shareholders of the company is a rights issue, different from a private placement.

Under CA 2013, bonus shares may be issued to its members by a company out of its free reserves or security premium account or capital redemption reserve account. Issuance of bonus shares in lieu of dividend has been prohibited. Additionally, the decision of the board of directors of the company to issue bonus shares, once announced may not be withdrawn.

While CA 1956 permitted issuance of shares at a discount subject to, inter alia, Central Government approval, CA 2013 prohibits issuance of shares at a discount other than sweat equity shares. even though shares of a public company are freely transferable, share transfer restrictions are enforceable as contract, for which action may be brought by the aggrieved party for injunction or damages.

Under the CA 2013 a cooling off period of 365 days has to be maintained between any 2 buy backs of shares, whether shareholder approved or board approved.

C. *Preference shares:*

As per Section 43(b) in the Companies Act 2013 Preference share capital means that part of the issued share capital of the company which carries or would carry a preferential right with respect to – a) Payment of dividend b) Repayment of the amount of the share capital paid-up or deemed to have been paid up .

In addition to their preferential rights, the following rights are also attached to the preference share capital. In respect of dividend - It has a right to participate, whether fully or to a limited extent, with capital not entitled to the preferential right. In respect of capital – It has a right to participate, whether fully or to a limited extent, with capital not entitled to that preferential right in any surplus which may remain after the entire capital has been repaid.

No company shall issue any preference shares which are irredeemable. The conditions to be complied with before issuing preference shares are : a) Articles of Association must authorize to issue preference shares; b) Approval of members is sought by way of special resolution in the general meeting; c) At the time of issue of preference shares. There should not subsist default in the redemption of preference shares issued either before or after the commencement of 2013 Act. No payment of dividend due on any preference shares.

The regulations that are to be included in the Articles of Association of a company, which intends to issue preference shares are: a) Priority with respect to payment of dividend or repayment of capital vis-à-vis equity shares; b) Participation in surplus dividend; c) Participation in surplus assets and profits, on winding up which may remain after the entire capital has been repaid; d) Payment of dividend on cumulative or non-cumulative basis; e) Conversion of preference shares into equity shares; f) Voting rights; g) Redemption of preference shares.

The minimum details that are required to be included in the explanatory statement to be annexed to the notice of the general meeting for issue of preference shares are: a) Size of the issue and number of preference shares to be issued and nominal value of each share; b) Nature of such shares viz. cumulative or non-cumulative, participating or non-participating, convertible or non-convertible; c) Objectives of the issue; d) Manner of issue of shares; e) Price at which such shares are proposed to be issued; f) Basis on which the price has been arrived at; g) Terms of issue, including terms and rate of dividend on each share, premium etc.; h) Terms of conversion, if convertible; i) Terms of redemption, including the tenure of redemption, redemption of shares at premium; j) Manner and modes of redemption; k) Current shareholding pattern of the company; l) Expected dilution in equity share capital upon conversion of preference shares.

Not exceeding 20 years from the date of issue is the maximum period which a company limited by shares, can

issue redeemable preference shares. A company may issue preference shares for a period exceeding 20 years but not exceeding 30 years for infrastructure projects (Specified in Schedule VI). However, it is subject to redemption of minimum 10% of such preference shares per year from the twenty first year onwards or earlier, on proportionate basis, at the option of the preference shareholders. Register of Members maintained under section 88 shall contain the particulars in respect of such preference shareholders. A company may redeem its preference shares only on the terms on which they were issued or as varied after due approval of preference shareholders under section 48 of the Act.

Capital Redemption Reserve account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares. Section 47 of CA 2013 prescribes restrictions on voting rights of preference shareholders. Although these restrictions mirror the restrictions that prevailed under the provisions of CA 1956, there are some differences:

CA 1956 gave private companies the freedom to structure their share capital and consequently preference shareholders of a private company were not subject to the restrictions on voting under the legislature. The CA 2013 removes this flexibility and consequently preference shareholders of both private and public companies will be subject to these restrictions.

The CA 1956 made a distinction between when preference shareholders holding cumulative or non-cumulative preference shares could exercise their respective voting rights. This distinction was based on the period for which the dividend remained unpaid. The CA 2013 has removed this distinction between cumulative and non-cumulative preference shares and entitles a preference shareholder to vote on every resolution placed before the company at any meeting if the company has not paid the dividend in respect of a class of preference shareholders for a period of consecutive 2 (two) or more years. That means Preference shares issued by private companies cannot have voting rights.

The main advantage of preference shares over equity shares is that: they enjoy a preferential right to dividend and Repayment of capital in case of winding-up of the company. The main drawback of preference shares is that they carry limited voting rights. [9]

Generally, an equity share confers on its holder a right to vote on all resolutions that require shareholder approval under the act, any other law, or the articles of association of the company. Equity shareholders, among others, enjoy the right to appoint and remove directors and auditors, and approve the company's accounts.

Therefore, the control of a company is in the hands of its equity shareholders. As distinguished from an equity share, a preference share carries voting rights only with respect to matters which directly affect the rights of the preference shareholders. Due to these limitations on voting rights, a preference shareholder does not have much control over the company. However, a preference shareholder may acquire voting rights on par with an equity shareholder if the dividend on preference shares is in arrears.

"Preference shares are not popular due to lack of liquidity. Once they start trading, there will be more buyers. Credit rating of the company is very important. It will help you understand what kind of company you are investing in and whether it will grow in size and popularity." says Raghvendra Nath, managing director of Ladderup Wealth Management[10]. To safeguard the interest of small investors from such high-risk securities, SEBI also said that the listing of privately placed non-convertible redeemable preference shares would require a minimum application size of Rs. 10 Lakh for each investor[11].The Securities and Exchange Board of India (SEBI) has allowed issuance and listing of non-convertible redeemable preference shares on stock exchanges, making it easier for companies and banks to raise funds through this route[12].

## V. Preference Share Capital in India

Preference capital is a unique type of long-term financing in that it combines some of the features of equity as well as debentures. As a hybrid security/ form of financing , it is similar to debenture in so far as: (i) it carries a fixed/stated rate of dividend, (ii) it ranks higher than equity as a claimant to the income/assets, (iii) it normally does not have voting rights and (iv) it does not have a share in residual earnings/assets. It also partakes some of the attributes of equity capital, namely, (i) dividend on preference capital is paid out of divisible/after tax profit, that is , it is not tax deductible, (ii) payment of preference dividend depends on the discretion of management, that is , it is not an obligatory payment of non-payment does not force insolvency/liquidation and (iii) irredeemable type of preference shares have no fixed maturity date. The main attributes of preference shares (i) prior claim on income/assets, (ii) cumulative dividends, (iii) redeemability, (iv) voting rights when preference dividend is in arrears, (v) participation in surplus profits/excess assets and so on. Preference capital involves high cost, does not dilute owners control of the company, has negligible risk and puts no restraint managerial freedom. The shareholders receive modest return and are vulnerable to arbitrary managerial actions. It is not a popular source of long term finance in India[13] .

Out of BSE Top 100 companies in terms of market capitalisation in the year2013-14, only five companies namely TCS, Adani ports, JSW Steel, United Breweries and Aditya Birla Nuvo ltd. are using preference share capital. Last five years Preference capital usage can be seen in Table -1. TCS has been maintaining 51.09% Preference capital as percentage to Equity capital from the year 2010 to year 2013. In the year 2014 TCS is not using preference capital. Adani ports has been maintaining 2.81 Crore as preference capital since the year 2010. JSW Steel has been maintaining 279.03 crores preference capital from 2010 to 2013. In 2014 it has increased preference capital to 764.44 crores that is 252.50% Preference capital as percentage to Equity capital. United

TABLE:1 PREFERENCE CAPITAL USAGE IN TOP BSE 100 COMPANIES

(Rupees in Crores)

| Company | Capital | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|---|
| TCS | Pref. Capital (PC) | 0 | 100 | 100 | 100 | 100 |
| | Equity capital(EC) | 195.87 | 195.72 | 195.72 | 195.72 | 195.72 |
| | PC as % of EC | 0 | 51.09 | 51.09 | 51.09 | 51.09 |
| Adani ports | Pref. capital | 2.81 | 2.81 | 2.81 | 2.81 | 2.81 |
| | Equity capital | 414.01 | 400.68 | 400.68 | 400.68 | 400.68 |
| | PC as % of EC | 0.68 | 0.7 | 0.7 | 0.7 | 0.7 |
| JSW Steel | Pref. capital | 764.44 | 279.03 | 279.03 | 279.03 | 279.03 |
| | Equity capital | 302.75 | 284.15 | 284.15 | 284.15 | 248.08 |
| | PC as % of EC | 252.5 | 98.2 | 98.2 | 98.2 | 112.47 |
| United Breweries | Pref. capital | 74.07 | 74.07 | 74.07 | 246.9 | 246.9 |
| | Equity capital | 26.44 | 26.44 | 26.44 | 25.45 | 24 |
| | PC as % of EC | 280.14 | 280.14 | 280.14 | 970.14 | 1028.75 |
| Adity Birla Nuvo ltd | Pref. capital | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| | Equity capital | 130.08 | 120.21 | 113.52 | 113.51 | 103.01 |
| | PC as % of EC | 0.07 | 0.08 | 0.09 | 0.09 | 0.09 |

(Filtered from Top BSE 100 companies in terms of market capitalization in 2013-14, Source: Money control)

TABLE:2 PREFERENCE CAPITAL USAGE IN BSE 500 COMPANIES

(Rupees in Crores)

| Company | Capital | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|---|
| GMR infra | Pref. Capital (PC) | 2,292.27 | 1,971.10 | 1,980.13 | 1,814.89 | 200 |
| | Equity capital (EC) | 389.24 | 389.24 | 389.24 | 389.24 | 366.74 |
| | PC as % of EC | 588.91 | 506.4 | 508.72 | 466.26 | 54.53 |
| DLF | Pref. capital | 1,799.20 | 1,799.20 | 1,799.20 | 1,810.26 | 5,919.86 |
| | Equity capital | 356.29 | 339.74 | 339.68 | 339.51 | 339.48 |
| | PC as % of EC | 504.98 | 529.58 | 529.67 | 533.2 | 1743.8 |
| KF Airlines | Pref. capital | 553.1 | 553.1 | 553.1 | 97 | 97 |
| | Equity capital | 808.72 | 577.65 | 497.78 | 265.91 | 265.91 |
| | PC as % of EC | 68.39 | 95.75 | 111.11 | 36.48 | 36.48 |
| Wockhardt | Pref. capital | 298.55 | 298.55 | 761.37 | 745.22 | 668.58 |
| | Equity capital | 54.88 | 54.79 | 54.72 | 54.72 | 54.72 |
| | PC as % of EC | 544 | 544.9 | 1391.39 | 1361.88 | 1221.82 |
| Gateway distr. | Pref. capital | 0 | 0 | 295.8 | 0 | 0 |
| | Equity capital | 108.61 | 108.5 | 108.28 | 108 | 107.9 |
| | PC as % of EC | 0 | 0 | 273.18 | 0 | 0 |
| Aban offshore | Pref. capital | 281 | 281 | 281 | 326 | 326 |
| | Equity capital | 8.7 | 8.7 | 8.7 | 8.7 | 8.7 |
| | PC as % of EC | 3229.9 | 3229.9 | 3229.9 | 3747.13 | 3747.13 |
| Max india | Pref. capital | 65.47 | 125 | 125 | 250 | 250 |
| | Equity capital | 53.25 | 53.1 | 52.91 | 46.5 | 46.47 |
| | PC as % of EC | 122.95 | 235.4 | 236.25 | 537.63 | 537.98 |
| JBF inds. | Pref. capital | 14.91 | 110.35 | 88.39 | 26.61 | 0 |
| | Equity capital | 65.32 | 72.63 | 72.02 | 71.65 | 62.24 |
| | PC as % of EC | 22.83 | 151.93 | 122.73 | 37.14 | 0 |
| Bhushan steel | Pref. capital | 103.72 | 101.59 | 85.94 | 68.69 | 36.68 |
| | Equity capital | 45.3 | 43.89 | 42.47 | 42.47 | 42.47 |
| | PC as % of EC | 228.96 | 231.46 | 202.35 | 161.74 | 86.37 |

Breweries used 246.90 crore preference capital in the year 2010 and 2011, but reduced to 74.07 crore and maintaining same thereafter. Aditya Birla Nuvo ltd has been maintaining 0.10 crore preference capital since the year 2010. This is evident from the Table-1.

Many Indian companies such as infrastructure firm GMR, real estate major DLF , pharmaceutical major Wockhardt, Aban offshore , Max India, Bhushan Steel etc. have issued far higher number of preference shares as compared to equity shares. Last five years Equity, Preference and Percentage of preference to Equity of these companies can be seen from the Table-2.

Preference shares are issued to raise funds from investors interested only in fixed dividend income and, in some cases of foreign investors, to avoid sector caps.

Companies that have issued preference shares to a large number of investors, including private equity, are in for a big surprise as the Act gives the same voting rights to preference shareholders as to equity capital holders. This will impact voting rights of all those companies whose Preference share capital is larger than their equity capital. While the Act is silent on whether this will be with retrospective or prospective effect, corporate lawyers say if implemented retrospectively, the clause may even lead to many promoters losing control over their companies, as and when the rule is notified[14].

## VI. CONCLUSION

The low priority accorded to the preference shares in the financing plans of companies' shows that this source has not been found productive by companies for raising long-term capital. Preference capital involves high cost, does not dilute control, has negligible risk and puts no restraint on managerial freedom. In spite of some changes in companies Act 2013, there is no significant changes in use of preference capital by Indian corporate firms. It is not a popular source of long-term finance in India.

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