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# HYBRID FINANCE

Debt and equity which are **combined into a single** instrument is known as a **hybrid security.**

**Foreign Currency Convertible Bond (FCCB):** A convertible bond that is denominated in a foreign currency is a subtype of a **convertible debenture**.

**US Dollar is one of the most common currencies used for the FCCBs.**

Debt

equity

# **ADVANTAGES HYBRID SECURITIES**

1. **HIGHER YIELD:** higher rate of return than debt
2. **LESS VOLATILE MARKET PRICE:** regular, pre-determined return.
3. **RISK DIVERSIFICATION**: do not have any strict definition of either equitable securities or debt securities

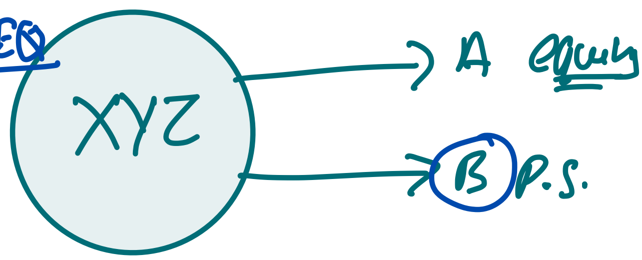
**DISADVANTAGES HYBRID SECURITIES**

**ASSESSMENT IS DIFFICULT:** Calculation of return is **not as simple**

## TYPES OF HYBRID SECURITIES

1. Preference Shares
2. Warrants
3. Convertible Debentures/ Bonds
4. Foreign Currency Convertible Bonds
5. Mezzanine Financing

Creditor > P.S > EQ




## PREFERENCE SHARE CAPITAL

- a **higher priority claim** on both the company's income and assets than the equity shareholders have.
- A **dividend is guaranteed** and this dividend must be paid out before any dividends are distributed to regular shareholders.

**in contrast to creditors**, **do not have a legal claim** to receive the dividend, which means that they are unable to push the company into bankruptcy if they are not paid.

**Organisations that assign ratings to corporate bond** offerings also assign ratings to issues of preference shares.

[Credit Rating Agencies like CRISIL, ICRA, CARE, Fitch etc., which are nationally recognised.]

## SALIENT PROVISIONS OF THE COMPANIES ACT, 2013

**As per Section 43**

A

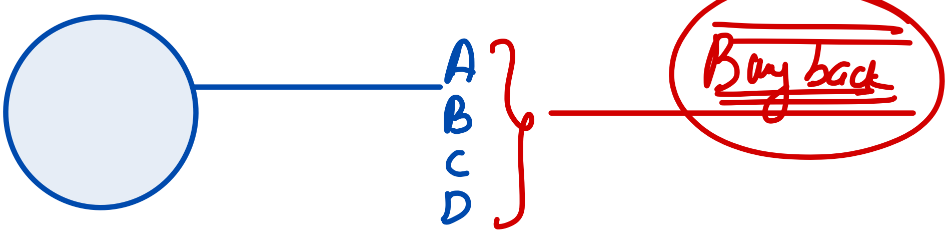
a) **Payment of dividend**, as a fixed amount or at a fixed rate.

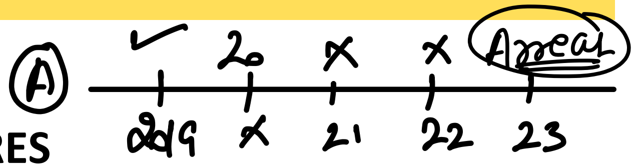
b) **Repayment** – in the case of a winding up or repayment of capital, with or without any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company.

- **Right to participate in dividends** over and above the preferential right to dividend
- **Right to participate fully or to a limited extent in the surplus left** on winding up after all payments are made

**[Section 47], where the dividend of preference shares has not been paid for a period of 2 years or more**, preference shareholders shall have a right to vote.

- **[SEC 55] issue of irredeemable shares is prohibited** and puts a limit of a period not exceeding 20 years from the date of issue
- But permits issue of preference shares for a period exceeding 20 years for infrastructure projects






## TYPES OF PREFERENCE SHARES

#1 **CUMULATIVE PREFERENCE SHARES:** holds the right to a **definite sum of dividend** or dividend at a predetermined rate.

- dividend on these shares will continue to accumulate unless they are completely paid out.

#2 **NON-CUMULATIVE PREFERENCE SHARES:** If for some reason a dividend is not declared throughout the course of a given year, the **right to receive** that dividend for that year will be forfeited.

PS
S
profit
↑dividend

#3 **PARTICIPATING PREFERENCE SHARES:** give the holder the right to participate in any surplus profits that remain after equity shareholders have been paid dividends at a predetermined rate regardless of whether or not the fixed dividend is paid out.

#4 **NON-PARTICIPATING PREFERENCE SHARES:** Does not get any additional rights in profits or in the surplus when the company is wound up.

#5 **REDEEMABLE PREFERENCE SHARES:** issued on the condition that the company will redeem them after the specified period or even earlier at the company's option.

Call option 5 year

#6 **NON-REDEEMABLE PREFERENCE SHARES:** can be redeemed by a company only on liquidation or shutting down of operations. Indian companies cannot issue irredeemable preference shares.

#7 **CONVERTIBLE PREFERENCE SHARES:** right to convert into equity shares, at their discretion, in accordance with the terms and circumstances of the issue of which they are a part.

#8 **NON-CONVERTIBLE PREFERENCE SHARES:** does not have the right to have his holdings converted into equity shares.

#9 **ADJUSTABLE-RATE PREFERENCE SHARES:** do not qualify for a fixed dividend rate and depend on interest rates prevalent in the market.

## PURPOSE OF ISSUING PREFERENCE SHARES

a) **improved method** for acquiring capital in an primary market.

b) possibility of getting one's money back at some point in the future could entice investors to invest in the company.

c) ***redeemed when there is a surplus of cash***

d) **If there is a loss or a reduction in profit,** there will be no dividend paid out, which is not the case with debentures or loans.

## UTILISATION OF PREFERENCE CAPITAL:

a) A **charge (mortgage/ hypothecation) is not necessary** to issue preference shares.

b) **Rules for the Acceptance of Deposits** do not apply to preference shares.

c) **possible to immediately issue preference shares** for the purpose of obtaining cash for the medium term, with flexible maturity periods.

F.V 100 + 200 Premium

face value

## METHODS OF REDEMPTION OF FULLY PAID-UP PREFERENCE SHARES (SECTION 55)

- **can be redeemed either on par or at a premium not at a discount.**
- Only **earnings available for dividends or funds from a new issue of shares** (not debentures) can be used to redeem

earning

- The **premium amount** (if any) will be paid out of earnings available for dividend or out of securities premium or debenture premium account if any is generated.
- The shares must be fully paid up for their redemption.
- does not result in a reduction in the company's share capital.

200 lakh

**when the shares are redeemed out of undistributed earnings, sum equivalent to nominal value of the redeemable shares, be transferred from profits to the Capital Redemption Reserve Account.**

P N C P

## PERPETUAL NON-CUMULATIVE PREFERENCE SHARES

AT – 1 max. 1.5% of RWA

- pays a fixed dividend to investors for as long as the company remains in business.
- It does not have a maturity**, nor a specific buyback date but does typically have redemption features.**

1. The instruments should **be issued by the bank** (not a bank-created SPV) and fully paid up.
2. Bank boards may decide how much **PNCPS to raise**.

- AT 1 Capital **cannot exceed 1.5% of risk-weighted assets**.
- **Once minimum total Tier 1 capital is met, any additional PNCPS issued by the bank can be added.**
- **Excess PNCPS can be considered Tier 2 capital if less than 2% of RWAs**, while meeting minimum Total Capital of 9% of RWAs.

3. PNCPS **have no maturity date**, step-ups, or redemption incentives.

PSC — fixed

4. Investor **dividends may be fixed or floating**
5. **PNCPS shouldn't have a "put option".** However, **banks may issue instruments with a call option at a specific date.**

- The call option is acceptable after it has run for at least 5 years
- **Clearance from RBI (Deptt of Regulation)**
- A bank must ***not do anything that generates an expectation*** **that the call will be exercised**

**Banks must not exercise a call unless:**

- **They replace the called instrument with capital of the same or better quality** at conditions sustainable for the bank's income capacity

PNCPS 150 100

- **its capital position is well above the minimum capital requirements** after the call. Exercise of calls due to tax event and regulatory event may be permitted.

tax

PNCPS

6. Principal of the instruments may be repaid (e.g., through repurchase or redemption) only with prior approval of RBI.

capital

7. Bank must have **full discretion at all times to cancel distributions/ payments**.
8. **PNCPS should absorb principal losses** at a pre-specified trigger point either by converting to common shares or by writing down the instrument.
9. Neither the bank nor a related party (by AS) should purchase PNCPS, nor should the bank directly or indirectly fund the purchase.
10. **The claims of investors in instruments shall be**

- Superior to the claims of equity investors;
- Subordinated to the claims of PDIs, all Tier 2 regulatory capital instruments, depositors, and general creditors of the bank
- Neither secured nor covered by a guarantee of the issuer nor related entity or other arrangement that legally or

economically enhances the seniority of the claim vis-à-vis bank creditors

11. FIIs and NRIs may invest up to 49% and 24% of the issue, respectively, with each investor limited to 10% and 5%.

## PREFERENCE SHARES ~~REDEMPTION BY FRESH ISSUE OF SHARES~~

undistributed earnings + SP

Section 52 of the companies Act, 2013 provides that the securities premium account may be applied by the company:

1. Towards issue of **un-issued shares of the company to be issued** to members of the company as fully paid bonus securities.


2. To **write off preliminary expenses**
3. To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company.
4. To provide **for premium on redemption of preference shares or debentures** of the company.
5. For the purchase of its own **shares or securities**.

PS 203

100 + 103 share premium