Preferred stock

Preferred stock (also called **preferred shares**, **preference shares** or simply **preferreds**) is a type of stock which may have any combination of features not possessed by common stock including properties of both an equity and a debt instrument, and is generally considered a hybrid instrument. Preferred stocks are senior (i.e., higher ranking) to common stock, but subordinate to bonds in terms of claim (or rights to their share of the assets of the company)[1] and may have priority over common stock (ordinary shares) in the payment of dividends and upon liquidation. Terms of the preferred stock are described in the articles of association.

Like bonds, preferred stocks are rated by the major credit-rating companies. The rating for preferreds is generally lower than for bonds because preferred dividends do not carry the same guarantees as interest payments from bonds and because preferred-stock holders' claims are junior to those of all creditors.

1 Features

Preferred stock is a special class of shares which may have any combination of features not possessed by common stock. The following features are usually associated with preferred stock:[2]

- Preference in dividends
- Preference in assets, in the event of liquidation
- Convertibility to common stock.
- Callability (ability to redeemed before it matures), at the option of the corporation
- Nonvoting

1.1 Preference in dividends

In general, preferred stock has *preference* in dividend payments. The preference does not assure the payment of dividends, but the company must pay the stated dividends on preferred stock before paying any dividends on common stock.[2]

Preferred stock can be *cumulative* or *noncumulative*. A cumulative preferred requires that if a company fails to pay a dividend (or pays less than the stated rate,) it must make up for it at a later time. Dividends accumulate with each passed dividend period (which may be quarterly, semi-annually or annually). When a dividend is not paid in time, it has “passed"; all passed dividends on a cumulative stock make up a dividend in arrears. A stock without this feature is known as a noncumulative, or *straight*,[3] preferred stock; any dividends passed are lost if not declared.[4]

1.2 Other features or rights

- Preferred stock may or may not have a fixed liquidation value (or par value) associated with it. This represents the amount of capital which was contributed to the corporation when the shares were first issued.[5]
- Preferred stock has a claim on liquidation proceeds of a stock corporation equal to its par (or liquidation) value, unless otherwise negotiated. This claim is senior to that of common stock, which has only a residual claim.
- Almost all preferred shares have a negotiated, fixed-dividend amount. The dividend is usually specified as a percentage of the par value or as a fixed amount (for example, Pacific Gas & Electric 6% Series A Preferred). Sometimes, dividends on preferred shares may be negotiated as *floating*; they may change according to a benchmark interest-rate index (such as LIBOR).
- Some preferred shares have special voting rights to approve extraordinary events (such as the issuance of new shares or approval of the acquisition of a company) or to elect directors, but most preferred shares have no voting rights associated with them; some preferred shares gain voting rights when the preferred dividends are in arrears for a substantial time. This is all variable on the rights assigned to the preferred shares at the time of incorporation.

The above list (which includes several customary rights) is not comprehensive; preferred shares (like other legal arrangements) may specify nearly any right conceivable. Preferred shares in the U.S. normally carry a call provision,[6] enabling the issuing corporation to repurchase the share at its (usually limited) discretion.

2 Types

In addition to straight preferred stock, there is diversity in the preferred stock market. Additional types of preferred stock include:

- *Prior preferred stock*—Many companies have different issues of preferred stock outstanding at one time; one issue is usually designated highest-priority. If the company has only enough money to meet the dividend schedule on one of the preferred issues, it makes the payments on the prior preferred. Therefore, prior preferreds have less credit risk than other preferred stocks (but usually offers a lower yield).

- *Preference preferred stock*—Ranked behind a company's prior preferred stock (on a seniority basis) are its preference preferred issues. These issues receive preference over all other classes of the company's preferred (except for prior preferred). If the company issues more than one issue of preference preferred, the issues are ranked by seniority. One issue is designated first preference, the next-senior issue is the second and so on.

- *Convertible preferred stock*—These are preferred issues which holders can exchange for a predetermined number of the company's common-stock shares. This exchange may occur at any time the investor chooses, regardless of the market price of the common stock. It is a one-way deal; one cannot convert the common stock back to preferred stock. A variant of this is the *anti-dilutive convertible preferred* recently made popular by investment banker Stan Medley who structured several variants of these preferred for some forty plus public companies. In the variants used by Stan Medley the preferred share converts to either a percentage of the company's common shares or a fixed dollar amount of common shares rather than a set number of shares of common.[7] The intention is to ameliorate the bad effects investors suffer from rampant shorting and dilutive efforts on the OTC markets.

- *Cumulative preferred stock*—If the dividend is not paid, it will accumulate for future payment.

- *Exchangeable preferred stock*—This type of preferred stock carries an embedded option to be exchanged for some other security.

- *Participating preferred stock*—These preferred issues offer holders the opportunity to receive extra dividends if the company achieves predetermined financial goals. Investors who purchased these stocks receive their regular dividend regardless of company performance (assuming the company does well enough to make its annual dividend payments). If the company achieves predetermined sales, earnings or profitability goals, the investors receive an additional dividend.

- *Perpetual preferred stock*—This type of preferred stock has no fixed date on which invested capital will be returned to the shareholder (although there are redemption privileges held by the corporation); most preferred stock is issued without a redemption date.

- *Putable preferred stock*—These issues have a "put" privilege, whereby the holder may (under certain conditions) force the issuer to redeem shares.

- *Monthly income preferred stock*—A combination of preferred stock and subordinated debt.

- *Non-cumulative preferred stock*—Dividends for this type of preferred stock will not accumulate if they are unpaid; very common in TRuPS and bank preferred stock, since under BIS rules preferred stock must be non-cumulative if it is to be included in Tier 1 capital.[8]

- *Supervoting stock*—a "class of stock that provides its holders with larger than proportionate voting rights compared with another class of stock issued by the same company."[9] It enables a limited number of stockholders to control a company. Usually, the purpose of the super voting shares is to give key company insiders greater control over the company's voting rights, and thus its board and corporate actions. The existence of super voting shares can also be an effective defense against hostile takeovers, since key insiders can maintain majority voting control of their company without actually owning more than half of the outstanding shares.[10]

3 Usage

Preferred stocks offer a company an alternative form of financing—for example through pension-led funding; in some cases, a company can defer dividends by going into arrears with little penalty or risk to its credit rating, however, such action could have a negative impact on the company meeting the terms of its financing contract.[11] With traditional debt, payments are required; a missed payment would put the company in default.

Occasionally companies use preferred shares as means of preventing hostile takeovers, creating preferred shares with a poison pill (or forced-exchange or conversion features) which are exercised upon a change in control. Some corporations contain provisions in their charters authorizing the issuance of preferred stock whose terms and conditions may be determined by the board of directors when issued. These "blank checks" are often used as a takeover defense; they may be assigned very high liquidation value (which must be redeemed in the event of a change of control), or may have great super-voting powers.

When a corporation goes bankrupt, there may be enough money to repay holders of preferred issues known as "senior" but not enough money for "junior" issues. Therefore, when preferred shares are first issued their governing document may contain protective provisions preventing the issuance of new preferred shares with a senior claim. Individual series of preferred shares may have a senior, pari-passu (equal), or junior relationship with other series issued by the same corporation.

4 Users

Preferred shares are more common in private or pre-public companies, where it is useful to distinguish between the control of and the economic interest in the company. Government regulations and the rules of stock exchanges may either encourage or discourage the issuance of publicly traded preferred shares. In many countries, banks are encouraged to issue preferred stock as a source of Tier 1 capital. On the other hand, the Tel Aviv Stock Exchange prohibits listed companies from having more than one class of capital stock.

A company may issue several classes of preferred stock. It may undergo several rounds of financing, with each round receiving separate rights and having a separate class of preferred stock. Such a company might have "Series A Preferred," "Series B Preferred," “Series C Preferred” and common stock.

In the United States there are two types of preferred stocks: *straight* preferreds and *convertible* preferreds. Straight preferreds are issued in perpetuity (although some are subject to call by the issuer, under certain conditions) and pay a stipulated rate of interest to the holder. Convertible preferreds—in addition to the foregoing features of a straight preferred—contain a provision by which the holder may convert the preferred into the common stock of the company (or, sometimes, into the common stock of an affiliated company) under certain conditions (among which may be the specification of a future date when conversion may begin, a certain number of common shares per preferred share or a certain price per share for the common stock).

There are income-tax advantages generally available to *corporations* investing in preferred stocks in the United States. See Dividends received deduction.

But for *individuals*, a *straight* preferred stock, a hybrid between a bond and a stock, bears some disadvantages of each type of securities without enjoying the advantages of either. Like a bond, a straight preferred does not participate in future earnings and dividend growth of the company, or growth in the price of the common stock. However, a bond has greater security than the preferred and has a maturity date at which the principal is to be repaid. Like the common, the preferred has less security protection than the bond. However, the potential increase in the market price of the common (and its dividends, paid from future growth of the company) is lacking for the preferred. One advantage of the preferred to its issuer is that the preferred receives better equity credit at rating agencies than straight debt (since it is usually perpetual). Also, certain types of preferred stock qualify as Tier 1 capital; this allows financial institutions to satisfy regulatory requirements without diluting common shareholders. Through preferred stock, financial institutions are able to gain leverage while receiving Tier 1 equity credit.

If an investor paid par ($100) today for a typical straight preferred, such an investment would give a current yield of just over six percent. If, in a few years, 10-year Treasuries were to yield more than 13 percent to maturity (as they did in 1981) these preferreds would yield at least 13 percent; this would reduce their market price $46, a 54-percent loss. The difference between straight preferreds and Treasuries (or any investment-grade Federal-agency or corporate bond) is that the bonds would move up to par as their maturity date approaches; however, the straight preferred (having no maturity date) might remain at these $40 levels (or lower) for a long time.

Advantages of straight preferreds may include higher yields and—in the U.S. at least—tax advantages; they yield about 2 percent more than 10-year Treasuries, rank ahead of common stock in case of bankruptcy and dividends are taxable at a maximum rate of 15% rather than at ordinary-income rates (as with bond interest).

5 Advantages of preference shares

1. No obligation for dividends: A company is not bound to pay a dividend on preference shares if its profits in a particular year are insufficient. It can postpone the dividend in case of cumulative preference shares also. No fixed burden is created on its finances.

2. No interference: Generally, preference shares do not carry voting rights.Therefore, a company can raise capital without dilution of control. Equity shareholders retain exclusive control over the company.

3. Trading on equity: The rate of dividend on preference shares is fixed. Therefore, with the rise in its earnings, the company can provide the benefits of trading on equity to the equity shareholders.

4. No charge on assets: Preference shares do not create any mortgage or charge on the assets of the company. The company can keep its fixed assets free for raising loans in future

5. Variety: Different types of preference shares can be issued depending on the needs of investors. Partic-

ipating preference shares or convertible preference shares may be issued to attract bold and enterprising investors.

6 Country-by-country perspectives

6.1 Canada

Preferred shares represent a significant portion of Canadian capital markets, with over C$5 billion in new preferred shares issued in 2005. Many Canadian issuers are financial organizations which may count capital raised in the preferred-share market as Tier 1 capital (provided that the shares issued are perpetual). Another class of issuer includes split share corporations. Investors in Canadian preferred shares are generally those who wish to hold fixed-income investments in a taxable portfolio. Preferential tax treatment of dividend income (as opposed to interest income) may, in many cases, result in a greater after-tax return than might be achieved with bonds.

Preferred shares are often used by private corporations to achieve Canadian tax objectives. For instance, the use of preferred shares can allow a business to accomplish an estate freeze. By transferring common shares in exchange for fixed-value preferred shares, business owners can allow future gains in the value of the business to accrue to others (such as a discretionary trust).

6.2 Germany

Preference shares in German stock exchanges are usually indicated with *V*, *VA* or *Vz* (short for *Vorzugsaktie*)—for example, “BMW Vz”[12]—in contrast to *St* or *StA* (short for *Stammaktie*) for standard shares.[13]

Preferred stock may comprise up to half of total equity. It is convertible into common stock, but its conversion requires approval by a majority vote at the stockholders’ meeting. If the vote passes, German law requires consensus with preferred stockholders to convert their stock (which is usually encouraged by offering a one-time premium to preferred stockholders). The firm’s intention to do so may arise from its financial policy (i.e. its ranking in a specific index). Industry stock indices usually do not consider preferred stock in determining the daily trading volume of a company’s stock; for example, they do not qualify the company for a listing due to a low trading volume in common stocks.[14]

6.3 United Kingdom

Perpetual non-cumulative preference shares may be included as Tier 1 capital. Perpetual cumulative preferred shares are Upper Tier 2 capital. Dated preferred shares (normally having an original maturity of at least five years) may be included in Lower Tier 2 capital.[15]

6.4 United States

In the United States, the issuance of publicly listed preferred stock is generally limited to financial institutions, REITs and public utilities. Because in the U.S. dividends on preferred stock are not tax-deductible at the corporate level (in contrast to interest expense), the effective cost of capital raised by preferred stock is 35 percent greater than issuing the equivalent amount of debt at the same interest rate. This has led to the development of TRuPS: debt instruments with the same properties as preferred stock. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, TRuPS will be phased out as a vehicle for raising Tier 1 capital by bank holding companies. Outstanding TRuPS issues will be phased out completely by 2015.[16]

However, with a qualified dividend tax of 15 percent (compared to a top ordinary marginal tax rate of 35 percent),[17] $1 of dividend income taxed at this rate provides the same after-tax income as approximately $1.30 in interest. The size of the preferred stock market in the United States has been estimated as $100 billion (as of early 2008), compared to $9.5 trillion for equities and US$4.0 trillion for bonds.[18]

6.5 Other countries

- *Czech Republic*—Preferred stock cannot be more than 50 percent of total equity.
- *France*—By a law enacted in June 2004 France allows the creation of preferred shares.
- *South Africa*—Dividends from preference shares are not taxable as income when held by individuals.
- *Brazil*—In Brazil, up to 50 percent of the capital stock of a company may be composed of preferred stock. The preferred stock will have at least one less right than the common stock (normally voting power), but will have a preference in receiving dividends.
- *Russia*—No more than 25% of capital may be preferred stock. Voting rights are limited, but if dividends are not fully paid, shareholders obtain full voting rights.

7 Notes

[1] Drinkard, T., A Primer On Preferred Stocks,

[2] Kieso, Donald E.; Weygandt, Jerry J. & Warfield, Terry D. (2007), *Intermediate Accounting* (12th ed.), New York: John Wiley & Sons, p. 738, ISBN 0-471-74955-9.

[3] Drinkard T.

[4] Kieso, Weygandt & Warfield 2007, p. 739.

[5] Harvard Business Services, Inc. Accessed February 23, 2007

[6] According to a Quantum Online table

[7] http://artfieldinvestmentsrdinc.info/blog/corporate-restructuring/

[8] Basel Committee on Banking Supervision [Minimum Capital Requirements http://www.bis.org/publ/bcbs128b.pdf] Accessed 2007-1-12

[9] http://financial-dictionary.thefreedictionary.com/Supervoting+Stock

[10] http://www.investopedia.com/ask/answers/05/070405.asp

[11] Heinkel, R. & Zechner, J. (1990), "The Role of Debt and Preferred Stock as a Solution to Adverse Investment Incentives", *Journal of Financial and Quantitative Analysis* **25** (1): 1–24 [p. 2], doi:10.2307/2330885.

[12] "eurex circular 036/07" (PDF). Frankfurt: Eurex Deutschland. 2007-02-27. p. 1. Retrieved 6 May 2010.

[13] "Stammaktie, Vorzugsaktie, Inhaberaktie, Namensakti Die Arten von Aktien" (in German). 2004-03-24. Retrieved 6 May 2010.

[14] "Stammaktie, Vorzugsaktie, Inhaberaktie, Namensakti Die Arten von Aktien" (in German). 2004-03-24. Retrieved 6 May 2010.

[15] FSA Handbook, PRU 2.2 Capital resources Accessed July 31, 2006

[16] The Yield Hunter

[17] CCH Incorporated Marginal and Effective Tax Rates Accessed September 18, 2006

[18] Standard & Poor's 2009-08-27

8 External links

- "The Many Flavors of Preferred Stock" at About.com

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9.1 Text

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