Web Chapter 16
Investing in Preferred Stocks

■ Summary

Preferred stocks are equities, but they don't perform like equities. They are income-producing securities, and thus have much in common with bonds. Preferred stocks are therefore often called hybrid securities. They do have many rather interesting characteristics, which this chapter explores.

Preferred stocks usually pay a fixed dividend, paid quarterly, which is eligible for a 70% income tax exclusion to corporations. Preferred dividends may be skipped if earnings are inadequate, but no common dividends can be paid until preferred dividends are paid. Preferreds are valued for their high and predictable current income, but a major disadvantage is their susceptibility to inflation and interest rate changes. Their price is found by using the zero-growth dividend valuation model. Most preferred stocks are cumulative, which means all missed preferred dividends must be made up before any common dividends may be paid. In the event of bankruptcy, preferred stockholders have a claim after bondholders but before common stockholders. Participating and floating rate preferreds offer special features, which make them attractive to some investors. An additional attraction was added when the 2003 tax law changed the tax rate on dividends to 15%. However, not all preferred stock dividends qualify for this preferred tax treatment. In the 1990s many companies issued preferreds that were considered debt securities. This helped the companies, because the interest expense was pretax on their income statement. But these are now at great disadvantage to individual investors, because their dividends will not qualify for the lower tax rate. Caveat emptor—buyer beware.

Preferred stocks may be callable, have sinking fund provisions, or be convertible into common stock. Preferreds are traded in the securities markets, and quotes, transaction costs, types of transaction orders, and margin requirements are the same as for common stock. The reason investors hold preferreds is their attractive current yield—but investors trading on interest rate expectations, or turnaround situations, hoping for capital gains also use them.

Learning goals for Chapter 16 are to:

1. Describe the basic features of *preferred stock*, including *sources of value and their risk*;
2. Discuss the rights and claims of *preferred shareholders*, and note some of the popular issue characteristics that are often found with these securities;
3. Understand the various *measures of investment worth,* and identify several *investment strategies* that can be used with preferred stocks.

■ Outline

I. *Preferred stocks* are *hybrid* securities that possess features of both common stocks and corporate bonds.
   A. *Preferred stock* has a prior claim (ahead of common) on the income and assets of the issuing firm.
      1. Preferred *dividends are paid quarterly* and are expressed either in $ or in %.

2. Preferred stock is equity and therefore does not add to a company's debt load. NB. In the 1990s a new type of preferred stock was created, so-called *trust preferred*, one that qualifies as debt for company tax purposes. Thus, the company deducts interest pre-tax on the income statement, and therefore the investor does not receive preferential tax treatment. The same preferred stock is treated as equity on the company's balance sheet—quite a neat little trick!
3. These securities trade on the yield they provide and are viewed as *competitive with bonds* by many investors. Like bonds, they come in a wide range of quality ratings.

B. There are several *advantages* to preferreds.
1. Most investors are attracted by current income.
2. For corporate investors, preferred dividends qualify for the *70% exclusion* from taxation of dividend income.
3. Although dividends are not guaranteed, historically companies have excellent record of meeting dividend payments, thus the level of safety is considered high.
4. Small investors are encouraged by the low unit cost of preferreds ($25-$50 per share).

C. There are also *disadvantages* to preferred investing.
1. Yields have not always kept up with inflation.
2. Capital gains potential is small relative to common stocks.
3. There is a yield give-up relative to bonds.
4. Preferred dividends may be suspended or 'passed.'
5. Currently, only about one-third of preferred stock issues qualify for the new low 15% tax rate on dividends.

D. *High-grade preferreds* derive their value from their dividend yields.
1. The value or price of a preferred issue is defined as:

$$\text{Price} = \frac{\text{annual dividend income}}{\text{prevailing market yield}}$$

2. Lower quality issues have a higher prevailing market yield.

E. Individual preferred issues may have *distinguishing characteristics*.
1. A *conversion feature* allows the holder of a convertible preferred to convert to a specified number of shares of the issuing company's common stock.
2. The level of annual dividends is fixed and such payments take priority over common stock dividends.
3. *Adjustable-rate (floating-rate)* preferreds are those whose dividends are adjusted periodically in line with yields on certain Treasury issues.
4. *Preference (prior preferred)* stock is a type of stock that has seniority over other preferred stock in its right to receive dividends and in its claim on assets.
5. A *cumulative provision* requires that any preferred dividends that have been passed must be paid in full before dividends can be restored to common shareholders.
   a. Being *in arrears* means having outstanding unfulfilled preferred dividend obligations.
6. *Non-cumulative provision* is found on some preferred stocks, excusing the issuer from having to make up any passed dividends.
7. Prior to purchase, determine whether stock has a *call feature* and/or a *sinking fund* provision.
8. *Deferred-call provision* means they can be called for a certain number of years after date of issue.
9. Some preferred stock issues have explicit maturity dates, albeit 30 years and more. These issues are considered debt for tax purposes (at the company level) and will not qualify for the lower 15% dividend tax rate (at the individual investor level).

II. *Valuing* and *investing* in preferreds means paying close attention to interest rates.

A. Dividend yield is a measure of the amount of return earned on the annual dividend:

$$\text{Dividend yield \%} = \text{dividend (\$)/price of stock}$$

Long-term investors may consider dividend yield a key factor, but short-term traders look at expected price behavior. Expected price can be found by forecasting future market interest rates.

B. *Book value (net asset value)* is a measure of the amount of debt-free assets supporting each share of preferred stock. The quality of an issue improves as the margin by which book value exceeds par value increases.

C. *Fixed charge coverage* is the term for how well a firm is able to cover its preferred stock dividends.

$$\text{Fixed charge coverage} = \frac{\text{earnings before interest and taxes (EBIT)}}{\text{interest expense} + \text{preferred dividends/0.65}}$$

Note: Dividends are adjusted by a factor of 0.65 because a company pays dividends from earnings that are left after taxes. 0.65 implies a (realistic) corporate tax rate of 35%.

Some analysts use EBITDA, which will result in a higher ratio. Additionally, if the preferred stock under consideration is the new debt-like variety, the adjustment factor of 0.65 should be dropped.

D. *Agency ratings* are provided by Moody's and S&P, much like they are for bonds.

E. Several *investment strategies* can be employed with preferred issues meeting a whole host of different investment objectives.

1. *Looking for yields*, especially those issues that qualify for the 15% tax rate is widely used.
2. *Monthly income preferred stock (MIPS)* is a hybrid that offers attractive tax provisions to the issuers and attractive monthly returns to investors.
3. Aggressive investors seeking *capital gains* may attempt to trade on interest rate expectations.
4. Investors who speculate on *turnarounds* seek out preferreds trading in arrears—having passed one or more dividends—which they feel will have an earnings turnaround. If they are correct, the value of the preferred will appreciate, past dividends will be paid, and a high return obtained. Clearly there are high risks associated with this strategy.

■ True/False

T _____ F _____ 1. Preferred stocks can be described as a special class of common stock.

T _____ F _____ 2. Preferred stock investors are exposed to business risk and interest rate risk.

T _____ F _____ 3. Preferred stock dividends are fixed obligations, which can be waived only by a vote of the preferred stockholders.

T _____ F _____ 4. When preferred stock is cumulative, any dividends in arrears automatically accumulate and are used to purchase additional shares of the preferred stock.

T _____ F _____ 5. Other things being equal, higher fixed charge coverage means lower default risk on a preferred issue.

T _____ F _____ 6. Adjustable-rate (floating-rate) preferreds carry dividends that are adjusted periodically in line with yields on the company's outstanding corporate bonds.

T _____ F _____ 7. The most popular investment strategy using preferred stocks is to speculate on turnaround situations.

T _____ F _____ 8. MIPS appeal to individual investors due to their monthly income feature—as opposed to conventional preferreds, which pay quarterly dividends.

T _____ F _____ 9. Preferred stock may produce a lower yield than a comparably rated bond.

T _____ F _____ 10. A preferred stock quote identified by *pr* instead of *pf* indicates the issue is selling above its par value.

T _____ F _____ 11. A preferred issue with a sinking fund provision will have a higher yield than a non-sinking fund issue.

T _____ F _____ 12. The price of $100 par 6% dividend preferred stock is $100 if investors require a 10% rate of return.

■ Multiple Choice Questions

1. Selma is considering the purchase of Timberline's non-callable, non-cumulative 8%, $100 par value preferred stock. Selma's required rate of return for investments of this risk is 12%. What is the investment value of this stock to Selma?
   (a) $100.00
   (b) its market price
   (c) its book value
   (d) $66.67

2. Preferred stocks have the following advantages, except:
   (a) they are available in a wide range of quality ratings.
   (b) they generally have high unit cost.
   (c) they have attractive yields.
   (d) they offer a relatively high degree of safety.

3. Which one of the following statements is true?
   (a) As interest rates move up, yields on preferreds move down.
   (b) As interest rates move up, the price of a preferred stock will also move up.
   (c) The price behavior of preferred stock is inversely related to market interest rates.
   (d) To define the price of a preferred stock, you divide the market yield with the preferred's annual dividend.

4. Which one of the following statements is not true?
   (a) To hedge against rising rates, investors turn to adjustable-rate preferreds.
   (b) There is far less price volatility with adjustables than with fixed-rate preferreds.
   (c) If a company's preferred dividend obligations are in arrears, a corporation cannot make dividend payments on common shares.
   (d) Preferreds whose dividends are qualified have no advantage over trust preferreds.

Problems

1. Martin Products has outstanding preferred stock that pays a $2 dividend and faces a prevailing market yield of 6%.
   (a) What should the price of the preferred stock be?
   (b) What will happen to the price if the prevailing market yield changes to 8%? To 4%?
   (c) Discuss the effect of changes in prevailing market yield on preferred share prices.

2. A preferred issue currently sells at $40 per share and pays a $1 annual dividend. An investor feels that prevailing market yield in two years will be 8%.
   (a) What is the present dividend yield?
   (b) What is the expected price of the issue in two years?

3. Bob's Bells has earnings before interest and taxes of $10 million. The company pays $2 million in annual interest and $1.5 million preferred dividends. What is the company's fixed charge coverage? The firm faces a 35% tax rate.

Answers

True/False

1. **False.** Preferred stock is equity but not common stock. Preferred stockholders do not normally vote and are not residual claimants as common stock shareholders are.

2. **True.** And purchasing price, financial, event, tax, and market risks.

3. **False.** Preferred dividends are fixed financial obligations, but can be waived by the company's directors if the required income level is not attained.

4. **False.** The cumulative provision requires the company to pay current dividends and any dividend arrearage to the preferred stockholders before any dividends can be distributed to the common stockholders.

5. **True.** Because the company has more earnings (and hopefully cash) to pay the dividends.

6. **False.** Those yields (thus dividends) are adjusted in line with yields on Treasury issues.

7. **False.** The most popular strategy for using preferreds is for high current income.

8. **True.** Straight preferreds pay dividends quarterly, just like common stock; MIPS pay monthly.

9. **True.** This is because up to 70% of dividends received by one company from another company are excluded from taxable income. This tax effect is reflected in market returns.

10. **False.** The symbol 'pr' indicates a preference or senior issue of preferred.

11. **False.** The sinking fund issue will have a lower yield because of lower risk to the investor.

12. **False.** Price is $60 = (0.06 \times 100)/0.10$.

Answers—Multiple Choice

1. The correct answer is D. Required return is the minimum return an investor will seek when selecting among alternatives. In this case, Selma's required return may be less than, equal to, or more than the prevailing market yield. Regardless of the prevailing market yield at its price, the maximum value for this preferred stock to Selma is $66.67 ($8/0.12).

2. Statement B is the correct answer. Many preferreds sell between $25 and $50 per share.

3. The correct answer is C. As with bonds, when rates go up, prices drop.

4. The correct answer is D.

Solutions to Problems

1. Price = dividend/yield
   (a) Price = $2/0.06 = $33.33
   (b) Price = $2/0.08 = $25.00
   Price = $2/0.04 = $50.00
   (c) Price is inversely related to prevailing market yield.

2. (a) Dividend yield = dividend/current price
   = $1/$40 = 2.5%.
   (b) Price = $1/0.08 = $12.50

3. $$\text{Fixed charge coverage} = \frac{\text{earnings before interest and taxes}}{\text{interest} + \text{preferred dividends}/0.65}$$

$$= \frac{\$10}{\$2 + \$1.5/0.65} = \frac{\$10}{\$4.31} = 2.32 \text{ times}$$