

CHAPTER: 17: COMMON AND PREFERRED STOCK FINANCING

1. Common Stockholder's Claim to Income

Common stockholders are the owner of the corporation and therefore have a claim to undistributed income, the right to elect the board of directors, and other privileges.

All income that is not paid out to creditors or preferred stockholders.

The income will be paid out as common stock dividends and reinvested as a retained earning with the hope of providing even greater income, dividends, and price appreciation in the future.

The common stockholders do not have a legal or enforceable claim to dividends.

2. The Voting Right

Founder' stock and class B.

Class B shares were used to differentiate between the original founders' shares and those shares sold to the public.

Common and class B stockowners share in dividends equally.

Bondholders and preferred stockholders may vote only when a violation of their corporate agreement exists.

3. Cumulative Voting

Cumulative voting provides minority stockholders with the potential for some representation on the board of directors.

Majority voting – any group of stockholders owning over 50 percent of common stock may elect all of the directors.

Cumulative voting – it is possible for those who hold less than a 50 percent interest to elect some of the directors.

- To determine the number of shares needed to elect a given number of directors under cumulative voting:

Share required

$$= \frac{\text{Number of directors desired} \times \text{Total number of shares outstanding}}{\text{Total number of directors to be elected} + 1} + 1$$

- To determine the number of directors that can be elected

Number of directors that can be elected

$$= \frac{(\text{Share owned} - 1) \times (\text{Total number of directors to be elected} + 1)}{\text{Total number of shares outstanding}}$$

4. The Right to Purchase a New Share

4.1. Rights offering

A sale of new common stock through a preemptive rights offering. Usually one right will be issued for every share held. A certain number of rights may be used to buy shares of common stock from the company at a set price that is lower than market price.

Rights on: Situation in which the purchase of a share of common stock includes a right attached to the stock.

Ex-rights: The situation in which the purchase of common stock during a rights offering no longer includes rights to purchase additional shares of common stock.

4.2. Margin Requirements

A rule that specifies the amount of cash or equity that must be deposited with a brokerage firm or bank, with the balance of funds eligible for borrowing. Margin is set by the Board of Governors of the Federal Reserve Board.

4.3. Poison pills

A strategy that makes a firm unattractive as potential takeover candidate. When a potential unwanted buyer accumulates a given percentage of a firm's common stock, the other shareholders receive rights to purchase additional shares at very low prices. Makes the firm more difficult to acquire.

Formulas:

- VALUE OF A RIGHT: $R = \frac{M_0 - S}{N + 1}$

R = Value of a right.

M_0 = Market value rights-on.

S = Subscription price.

N = Number of rights necessary to purchase a new share.

- THE MARKET VALUE OF THE STOCK EX-RIGHTS: $M_e = M_0 - R$

M_e = Market value of the stock ex-rights.

5. American Depository Receipts (ADRs)

American Depository Receipts are certificates that have a legal claim on an ownership interest in a foreign company's common stock.

ADRs are a type of stock traded in the United States, but it represents a number of shares of a foreign corporation. ADRs are traded on the US stock market like ordinary stocks and are issued or funded by a bank or brokerage firm.

ADRs were created to solve the difficulty of buying shares of foreign companies in the context of those securities being traded at different prices, and in a different currency. Banks in the United States simply buy a large batch of shares from a foreign company, combine them into packages and reissue them on either NYSE or AMEX (or NASDAQ) exchanges.

There are many advantages to American Depository Shares for the US investor. Dividends are paid in dollars and are more easily collected than if the actual shares of the foreign stock were owned. Although ADRs are considered to be more liquid, less expensive, and easier to trade than buying foreign companies' stock directly on that firm's home exchange, there are some drawbacks.

Eventhough the ADRs are trade in US market in dollars, they are still traded in their own country in their local currency.

6. Preferred Stock Financing

Preferred stock is an intermediate type of security that falls somewhere between debt and common stock.

Justification for preferred stock: it is a means of expanding the capital base of the firm without diluting the common stock ownership position or incurring contractual debt obligations.

Investor interest: Primary purchasers of preferred stock (corporate investors) which offers a very attractive advantage over bonds. Only 30% of the dividend would be taxable, all the interest of bonds is taxable to the recipient except for municipal bond interest.

Summary of tax considerations: For issuing corporation, the aftertax cost of debt is cheaper than preferred stock. For corporation investor, the receipt for preferred dividends is more valuable than corporate bond interest.

Formulas:

Aftertax bond yield = Before-tax bond yield x (1 – tax rate)

Aftertax preferred yield = Before-tax preferred stock yield x [1 – (tax rate x 0.3)]

7. Provisions Associated with Preferred Stock

7.1. Cumulative Dividends

This term refers to accumulated dividends of preferred securities, which will be paid to the current owner. Preferential securities in the situation that the issuers have restored their profit-making prospects will attract buyers when they are sold at lower prices (discounted prices) and have accumulated dividends (dividends in the debt will be Postpaid).

7.2. Conversion Feature

A conversion is the exchange of a convertible type of asset into another type of asset, usually at a predetermined price, on or before a predetermined date. The conversion feature is a financial derivative instrument that is valued separately from the underlying security.

7.3. Call Feature

A corporation may forcibly redeem a callable preferred stock on or after a specified call date. Corporations usually defer the call date for five or more years after issue. The pre-established call price may be equal or slightly higher than the stock's issue price. When a corporation calls a stock, it immediately cancels the shares and delivers cash, including any dividends due, to the former shareholders. A corporation might want to call preferred shares when prevailing interest rates fall.

7.4. Participation provision

Participating preferred stock is a type of preferred stock that gives the holder the right to receive dividends equal to the normally specified rate that preferred dividends are paid to preferred shareholders, as well as an additional dividend based on some predetermined condition. Participating preferred stock can also have liquidation preferences upon a liquidation event.

7.5. Floating rate

These issues have floating rates from the day they are issued and always contain a floating rate formula with an overriding minimum coupon, usually 3% - 4.5%. Most of these issues use 3 months labor as part of the equation and add a fixed rate to 3 months labor. As of 2/2018 most of these issues may be "safe" issues, but the coupons are substandard.

As of 5/2017 most fixed to floating rate preferred are trading higher after issuance. This is because we are now in an interest tightening phase and income investors are trying to assure their future income stream by capturing potential higher floating rate coupons in the future.

7.6. Dutch Auction Preferred Stock

Dictionary of Finance and Investment Terms for: dutch auction preferred stock type of adjustable-rate preferred stock whose dividend is determined every seven weeks in a dutch auction process by corporate bidders. Shares are bought and sold at face values ranging from \$100,000 to \$500,000 per share. Also known as auction rate preferred stock, Money Market Preferred Stock (Lehman Brothers Inc.), and by such proprietary acronyms as DARTS (Salomon Smith Barney Inc.).

7.7. Par Value

Par value is the stock price stated in a corporation's charter. The intent behind the par value concept was that prospective investors could be assured that an issuing company would not issue shares at a price below the par value. However, par value is now usually set at a minimal amount, such as \$0.01 per share, since some state laws still require that a company cannot sell shares below the par value; by setting the par value at the lowest possible unit of currency, a company avoids any trouble with future stock sales if its shares begin to sell in the penny stock range.

8. Comparing Features of Common and Preferred Stock and Debt

BASIS FOR COMPARISON	COMMON STOCK	PREFERRED STOCK
Meaning	Common stock refers to the ordinary stock, representing part ownership and confers voting rights to the person holding it.	Preferred stock, represents that part of company's capital that carry preferential right, to be paid, when the company goes bankrupt or wound up.
Growth potential	High.	Low.
Rights	Differential Rights.	Preferential Rights.
Return on capital	Not guaranteed.	Guaranteed and that too, at a fixed rate.
Participation in elections	Entitles a person to participate and vote in the company's meeting.	Does not entitles a person to participate and vote in the company's meeting.
Repayment priority	Payment to common stockholders are made at the end.	Preferred stockholders are paid before common stockholders.
Redemption	Cannot be redeemed.	Can be redeemed.

Conversion	Not possible.	Possible.
Arrears of dividend	They are not entitled to arrears of dividend, if skipped in the previous year.	They are entitled to arrears of dividend, if skipped in the previous year.

Key Differences Between Common and Preferred Stock

The difference between common and preferred stock are discussed in detail, in the points given below:

Common Stock, implies the type of stock ordinarily issued by the company to raise capital, indicating part ownership and carry voting rights. Preferred Stock is that class of stock, which gets priority regarding the payment of dividend and repayment of capital.

Common Stock has high growth potential, as compared to preferred stock, whose propensity to grow is slightly low.

Common Stockholders return on capital is neither guaranteed, nor the amount is fixed. Unlike preferred stockholders, whose return is guaranteed and that also at a fixed rate.

Common Stock carries differential rights regarding voting, dividend and repayment of capital. On the other hand, the preferred stock holds preferential rights as to the dividend and capital repayment.

Common stock entitles a person to participate and votes in the company’s general meeting. As against this, preferred stock does not allow a person to participate and vote in the company’s general meeting.

Common Stock can never be redeemed by the company. Conversely, preferred stock is redeemed by the company, either on their maturity or when the company wants to buy back.

Common Stock cannot be converted into any other security, whereas preferred stock can easily be converted into common stock or debt.

Common stockholders are not entitled to an arrear of dividend, if not paid by the company in the previous year, due to insufficient funds. On the flip side, preferred stockholders are

entitled to arrears of dividend, if it is skipped in the previous year, or else they acquire voting rights if the company skips dividend payment for three consecutive years.

Preferred Stocks

Holding stock in a company means having ownership or equity in that firm. There are two kinds of stocks an investor can own: common stock and preferred stock. Common stockholders can elect a board of directors and vote on company policy, but they are lower in the food chain than owners of preferred stock, particularly in matters of dividends and other payments. On the downside, preferred stockholders have limited rights, which usually does not include voting.

When a company is going through liquidation, preferred shareholders and other debtholders have the rights to company assets first, before common shareholders. Preferred shareholders also have priority regarding dividends, which tend to yield more than common stock and are paid monthly or quarterly.

Bonds (Debt)

A corporate bond is a debt security that a company issues and makes available to buyers. The collateral for the bond is usually the company's creditworthiness, or ability to repay the bond; collateral for the bonds can also come from the company's physical assets.

Corporate bonds are a more high-risk investment for investors than government bonds. The higher the risk, the higher the interest rates on the bond. This is even true for companies with excellent credit quality.

Key Similarities

Interest rate sensitivity

Both bond and preferred stock prices fall when interest rates rise. Why? Because their future cash flows are discounted at a higher rate, offering better dividend yield. The opposite happens when interest rates fall.

Callability

Both securities may have an embedded call option (making them "callable") that gives the issuer the right to call back the security in case of a fall in interest rates and issue fresh securities at a lower rate. This not only caps the investor's upside potential but also poses the problem of reinvestment risk.

Voting rights

Neither security offers the holder [voting rights](#) in the company.

Capital appreciation

There is very limited scope for [capital appreciation](#) for these instruments because they have a fixed payment that does not benefit them from the firm's future growth.

Convertibility

Both securities may offer this option, which allows investors to convert the bonds or preferreds into a fixed number of shares of the [common stock](#) of the company, which allows them to participate in the firm's future growth.

Investors concerned about putting money into preferred stock can instead buy mutual funds that invest in preferred stocks of various companies; this gives the benefit of a high dividend yield and risk [diversification](#).

Key Differences

Seniority

In case of [liquidation](#) proceedings – a company going bankrupt and being forced to close – both bonds and preferred stocks are senior to common stock; that means investors holding them rank higher on the [creditor repayment](#) list than common-stock shareholders do. But bonds take precedence over preferred stocks: Interest payments on bonds are legal obligations and are payable before taxes, while dividends on preferred stocks are after-tax payments and need not be made if the company is facing financial difficulties. Any missed dividend payment may or may not be payable in the future depending on whether the security is [cumulative or non-cumulative](#).

Risk

Generally, preferred stocks are rated two notches below bonds; this lower rating, which means higher [risk](#), reflects their lower claim on the [assets](#) of the company.

Yield

Preferred stocks have a higher [yield](#) than bonds to compensate for the higher risk.

Par value

Both securities are usually issued at [par](#). Preferred stocks generally have a lower [par value](#) than bonds, thereby requiring a lower investment.

Special Considerations

[Institutional investors](#) like preferred stocks due to the preferential tax treatment the dividends receive (70% of the dividend income can be excluded on corporate tax returns). This may suppress yields, which is negative for [individual investors](#).

The very fact that companies are raising capital through preferred stocks could signal that the company is loaded with debt, which may also pose legal limitations on the amount of additional debt it can raise. Companies in the [financial](#) and [utilities sectors](#) mostly issue preferred stocks.

Yet, the high yield of preferred stocks is definitely a positive, and in today's [low-interest rate environment](#), they can definitely add value to a [portfolio](#). Adequate research needs to be done about the financial position of the company, however, or investors may suffer losses.

Another option is to invest in a mutual fund that invests in preferred stocks of various companies. This gives the dual benefit of a high dividend yield and risk [diversification](#).