

tied to another benchmark, such as 3% above the interest rate on 90-day Treasury bills. The rate is reset quarterly, making the prices of adjustable-rate preferred less sensitive to interest rate changes than fixed-rate preferred. For this reason, adjustable-rate preferred stock typically pays lower dividends than fixed-rate preferred.

Dividends are not a fixed obligation of the company like the interest rate on a bond: They come out of earnings and a company may decide not to pay them. However, if common stockholders are offered a dividend, the preferred shareholders will receive their dividends before the common shareholders receive their first dime.

EXAMPLE QUESTION

XYZ issues preferred stock with a 10% annual dividend. The par value on the preferred stock is \$100 per share. The share price of the preferred stock is \$110, and the share price of the common stock is \$200. What is the quarterly per-share dividend on the preferred stock?

Answer: \$2.50

Explanation: The annual dividend would be par value times dividend rate ($\$100 \times 0.10 = \10.00). The quarterly per-share dividend will be \$2.50. The current price of the preferred stock and common stock are irrelevant to calculating the dividend.

1.3.2. LIQUIDATION

In addition to receiving preference over common stockholders regarding dividends, preferred stockholders also receive preference over common stockholders if the issuing company goes bankrupt. In the event of a liquidation bankruptcy (Chapter 7 bankruptcy), a company's assets are sold and the proceeds distributed first to the company's creditors. Only after creditors have been paid are any remaining assets then distributed to shareholders. Among shareholders, preferred stockholders have first claim on these residual assets before common shareholders.

1.3.3. ISSUANCE OF PREFERRED STOCK

Companies generally issue preferred stock when the sale of bonds or common stock is not feasible. For example, a company seeking to acquire the assets of another company in a merger may issue preferred stock to use in exchange for the other company's assets so as not to dilute its own voting control. A company with unstable earnings may issue preferred stock because it is discouraged by the high interest payments it faces in the bond market. Or a company may wish to maintain liquidity on its balance sheet by avoiding the legal obligation of paying periodic interest on a bond. Alternatively, a company may issue preferred stock because of market demand. Preferred stock returns can be particularly attractive to corporations, which receive a 70% "dividend received" tax deduction on preferred dividends.

1.3.3.1. Value at Issuance

Unlike common stock, preferred stock certificates have a face value, or par value, that actually means what it says. Most preferred stock is issued with a par value of \$25, \$50, or \$100. While \$25 is the most common par value, on the Series 7 exam, you are likely to see questions with a par value of \$100 to make calculations easier.

Par value represents the claim of the preferred shareholder against the value of the firm during liquidation. This means that if the company goes bankrupt, it is the amount of money that the preferred shareholder can claim. Unlike a bondholder, who receives the par value at maturity, preferred shareholders do not receive the par value at maturity. Instead, they are purchasing equity in the company and the right to receive dividends in perpetuity, that is, throughout the life of the corporation.

1.3.4. TRANSFER OF PREFERRED STOCK

Preferred stocks trade in the secondary market, but price fluctuations are caused by changing interest rates rather than increases and decreases in company earnings. As with bonds, preferred stock appreciates in value with falling interest rates and decreases with rising interest rates. When interest rates fall, the price of the preferred stock will usually rise above par, and when interest rates rise, the price of the preferred stock will fall below par. Since they behave more like bonds, preferred stocks tend not to fluctuate as dramatically in price as common stocks.

Preferred shares are held mostly by corporations, which can deduct 70% of the dividends from their taxable income. Individual investors must pay taxes on the full dividend received, though, usually at the 15% qualified dividends rate. Dividends are taxed as ordinary income when individuals have not owned the stock beyond a given “holding period.”

1.3.5. CLASSES OF PREFERRED STOCK

1.3.5.1. Cumulative Preferred Stock

Corporations can offer different types of preferred stock. **Cumulative preferred stock** allows dividends to accumulate when a payment is not made. If a corporation misses a dividend payment, it will have to pay the accrued dividend the next time it offers a dividend, before it pays common stockholders. **Non-cumulative preferred stock** does not accrue unpaid dividends. Few companies issue shares of non-cumulative preferred, since they are unattractive to investors, but terms may sometimes be added to improve their value, such as fixing the number of allowable missed payments or automatically granting voting rights when a payment is missed. Non-cumulative will typically offer higher dividends than cumulative preferred stock.

EXAMPLE QUESTION

Ruby Red Jewelry has issued both common stock and cumulative preferred stock. The

cumulative preferred stock pays an 8% annual dividend on stock with a \$100 par value. Ruby Red Jewelry has not paid a common or preferred dividend for two quarters. It has committed to pay a \$2 per share dividend to its common stockholders. How much will it be required to pay its preferred shareholders per share?

- A. \$0
- B. \$2
- C. \$5
- D. \$6

Answer: D

Explanation: Before Ruby Red Jewelry can pay its common stockholders a dividend, it must pay its cumulative preferred shareholders their dividend and all missed dividends. Ruby Red must pay \$2 per share for each quarterly dividend ($8\% / 4 \text{ quarters} \times \$100 = \$2$). It must pay two missed dividends and the current dividend, for a total of \$6.

1.3.5.2. Participating Preferred Stock

Participating preferred stock allows investors to receive extra dividends when the company exceeds some predetermined financial goals. Investors will always receive their regular dividend but may also participate in a company's accelerated growth. Participating preferred also often receives a greater claim during liquidation than **non-participating preferred**. For example, participating preferred may receive 120% of its invested value rather than 100% of its invested value. Participating preferred stock is extremely rare. Most preferred stock is non-participating.

1.3.5.3. Convertible Preferred Stock

Like participating, **convertible preferred stock** allows shareholders to participate in the growth of a company. These investors have the right to convert their preferred shares to common stock at a set **conversion ratio**. This exchange may occur any time at the investor's sole discretion. If a \$25 certificate may be traded for five shares of common stock (or for \$5 per share) and the common stock rises to \$10, the price for the preferred stock in the secondary market will rise to around \$50 ($\$10 \times 5 \text{ shares}$). The preferred shareholder has the option to sell the certificate or convert the issue and receive five shares of stock. Because convertible preferred stock can be converted to common stock, its price is more dependent on the price of the company's common stock than on changes in interest rates.

EXAMPLE QUESTION

A \$100 convertible preferred stock certificate is issued in March 2017. The stock pays 4% in dividends and is convertible at \$20. The price of the company's common stock at issue was \$10.27 per share. On the conversion date of March 15, 2017, the common stock is at \$13.10 per share. What is the conversion parity price for the preferred share, if the shareholder converts on the conversion date?

- A. \$51.35
- B. \$20.00
- C. \$65.50
- D. \$100.00

Answer: C

Explanation: The convertible price tells the shareholder how many shares of common stock she will get for one share of convertible preferred stock. To find the number of shares, divide the convertible price into the face value of the preferred stock. In this example, it is $\$100 / \$20 = 5$. Thus, the conversion ratio is 5; the shareholder will receive 5 shares of common stock upon conversion. The conversion parity price is the current market value of the preferred share if converted. It is calculated by multiplying the current market price by the conversion ratio ($\$13.10 \times 5 = \65.50). If the convertible is trading at lower than \$65.50, the investor will want to convert her shares. If the convertible preferred is trading at higher than \$65.50, the investor will want to hang on to her shares.

1.3.5.4. **Callable Preferred Stock**

Many preferred stocks are also callable. **Callable preferred stock** gives the issuing company the right to call in its shares after some set date at a set price. An issuer will usually choose to call in the stock if interest rates drop and the issuer can issue new preferred stock at a lower rate. Callable preferred shares are usually redeemed at a premium to par. For example, if the shares have a par value of \$100, the investor may receive \$110 to redeem the shares. Callable preferred stock tends to pay higher dividends than non-callable stock to compensate for the fact that the stock may be called.

1.3.6. **PROTECTIVE PROVISIONS**

Protective provisions are a relatively standard feature of preferred stocks, often written into a company's certificate of incorporation. Protective provisions permit preferred shareholders to veto certain actions by the company, such as the sale or merger of the company and the raising of capital. They are designed to protect the preferred stockholders, which are almost always the minority shareholders, from the dilution of their investment by the common shareholding majority. These veto rights extend to:

- Any sale or dissolution of the company
- The issue of new shares of stock
- The issue of new debt beyond some stated amount
- A change to the certificate of incorporation or bylaws
- Changes to any rights of other shares that give better rights than their preferred shares

Protective provisions also protect one class of preferred shareholders against another. Series A preferred shareholders, for example, might object to the issuance of a Series B