LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com

TUESDAY, OCTOBER 1, 2019

PERSPECTIVE

A primer on preferred: *Getting your yield's worth*

By Sara L. Terheggen

Shutterstock

Preferred stock in the context of an underwritten registered transaction by a public company catches the eye of many income-focused investors as they can offer attractive yields through ongoing dividend payments. This is especially true in an environment like we are in now with declining interest rates. Similar to common stock, preferred stock is equity in a company but with debt-like qualities. Preferred stock ranks senior to common but junior to debt. Similar to common stock, preferred stock is often listed on NASDAQ or NYSE and trades at a different price than common stock. Opportunities such as preferred stock can be quite attractive for investors looking for a steady return.

Many companies also like the option of issuing preferred stock as it offers their investors an opportunity to invest in the equity of the company without giving up much in the way of voting control. It also allows companies an alternative to issuing debt. Since institutional investors tend to gravitate towards preferred stock transactions, such offerings can also provide companies with a stronger, more reputable investor base. On the downside, dividends (unlike interest payments on debt) are not tax-deductible.

Investors who are focused on long-term investments that produce a fixed rate of return over time are likely to seek out investment opportunities in preferred stock. The difficult aspect of investing in preferred stock is understanding what characteristics are best suitable depending on an investor's risk profile and choosing those opportunities that provide the best yield.

Breaking Down Preferred Stock

Generally speaking, and compared to other types of capital raising options that companies can bring to the market, preferred stock is complicated. The rights, privileges, rates, voting, conversion, redemption and form can differ from company to company so it can be difficult for an investor to determine which offering best fits their risk profile. Let's break down the key components.

Form and Issuance: Preferred stock must be authorized by a company's charter. To the extent the board of directors did not include "blank check" authorization to issue preferred stock shares, then a shareholder vote can be obtained to amend the charter. Preferred stock is often created in series (Series A, Series B, etc) and one series can be assigned certain rights and preferences senior to another series. Once determined by the Board, the Company will file an amendment to their certificate of incorporation that authorizes the series and outlines the terms applicable to such series.

Dividends: The two key characteristics for dividends to consider are payments and protection. With respect to payments, this is specific to the rate being paid on the preferred stock. Certain companies with a higher credit risk may offer a higher dividend rate while others may stick with a lower dividend rate. Protection has to do with whether the dividends are cumulative or non-cumulative. Cumulative dividends allow a company to suspend dividends but those dividends will accumulate and must be paid in a later quarter in full. For non-cumulative dividends, if it is determined that no dividends can be paid out, then the company is not obligated to make up such missed dividend payments.

Liquidation Preference: Liquidation preference provides preferred stock holders with an advantage over common stock holders by ensuring they are paid out first in a dissolution, liquidation or wind-up of a company. The value of the liquidation preference is most often equal to the purchase price and in the case of cumulative preferred stock would include any accrued accumulated dividends.

Redemption Rights: When considering redemption rights, it is helpful to group the various factors around redemption into two categories: price and circumstances. For price, one should consider whether the redemption price is fixed or floating and whether a premium will be paid at the time of a redemption or if there is a minimum threshold on the number of shares that will be redeemed. The second category has to do with circumstances. An optional redemption by the company is common although there is typically a time period in which such preferred stock cannot be redeemed, often five years. Certain companies will also provide for special redemption options in connection with a change of control or delisting event.

Voting Rights: Most preferred stock in an underwritten registered offering is sold with no voting rights except in very limited circumstances that are considered investor protections. For example, investors who hold preferred stock may be entitled to vote on things like amending the company's charter, authorizing or creating any class or series that ranks senior to them, taking actions that would be considered adverse to the preferred stock holders or purchasing or redeeming shares junior to the preferred stock holders.

Board Representation: In an underwritten registered offering, the ability of preferred stockholders to appoint members of the board is often only included as a trigger in the event the company fails to pay a certain number of consecutive dividend payments.

Conversion Rights: Preferred stock may have the ability to convert into common stock in certain contexts, most often a change of control. Such conversion can occur at a fixed price as outlined in the company's certificate of designation for the preferred stock series or it can be a floating rate that is tied to the market price of the common stock.

Executing a Preferred Stock Transaction

Similar to a typical follow-on offering, preferred stock transactions are executed in a very similar fashion. Companies will most often register preferred stock on their universal shelf registration statements on Form S-3, along with common stock, warrants, depositary shares, debt securities and units. To undertake a preferred stock offering, companies will file a preliminary prospectus supplement just as they would in a follow-on offering for common stock. They may also first participate in confidential marketing prior to launch. Depending on whether they have sufficient preferred stock authorized under their charter, a company may issue depositary shares which allow preferred stock to be carved up into fractional interests, such that each depositary share is 1/100th or 1/1000th of a preferred share.

The other aspects of a preferred stock offering are very similar to a typical underwritten public offering. The auditors will deliver comfort letters and a series of closing documents are delivered, including opinions, officers certificates and transfer agent documentation. If a company is issuing depositary shares, a deposit agreement and form of depositary receipt will also be included in the necessary closing documents. In addition to the documentation, underwriters and their counsel will undergo diligence, including reviewing public filings, participating in diligence calls and possibly requesting additional documentation. Underwriters may also request a CFO certificate to comfort certain numbers that the auditors will not comfort and may want factual back-up on certain statements in the prospectus supplement or roadshow deck. In addition to general closing documents, the company will have to file a certificate of designation or other amendment to their certificate of incorporation establishing the terms of the preferred series.

With respect to filings, the company will need to obtain NASDAQ or NYSE approval for listing of the preferred stock or the depositary shares. The company will obtain a new ticker symbol for the preferred stock issuance and respond to comments from the relevant exchange. Because preferred stock can be quite complicated, the exchange will want to review the terms and provide sign-off. In addition to the exchange filing, the underwriters will get FINRA approval for those companies who are not exempt. This will require completion of FINRA questionnaires for directors and officers, a company questionnaire and payment of a filing fee.

Maximizing Yield, Minimizing Risk

Preferred stock offers several advantages to both companies and investors. For companies to maximize their ability to do a preferred stock offering, they should be sure to add preferred stock and depositary shares to their universal shelf and provide for their board to have some "blank check" authority in the charter. For investors, the key is understanding and breaking down the various components of preferred stock being offered to determine if the characteristics are consistent with one's risk profile and expectations for a return. Currently, in a market where yield is scarce, preferred stock can be an interesting investment opportunity to diversify the portfolio. ■

Sara L. Terheggen, Ph.D. ("Dr. T") *is the founder and Managing Director of The NBD Group, Inc., a leading legal and business solutions firm. Dr. T has advised on transactions with an aggregate value of more than $100 billion and she has been recognized more than 40 times for her professional expertise and leadership.*