

BUSINESS VALUATION REVIEW

CLOSELY HELD PREFERRED STOCK: A REVIEW OF THE COMMON VALUE-DRIVERS

by

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PREFERRED STOCK — GENERAL

Preferred shares in private corporations (also referred to in Canada as “special shares”) are fixed-income securities¹ having a predetermined, or contractually fixed, income (dividend) stream accruing to the holder—unlike common stock, which has an uncertain or contingent income stream (even though there may be a dividend rate, e.g., \$X per share, attaching to them).

Traditional (or straight) preferred stock carries a dividend which is permanently fixed, expressed either as a percentage of the stated value or a constant dollar amount. Before any dividends may be paid on the issuer’s common stock in a particular period, dividends must first be paid on its preferred stock.

As preferred shares do not share in the growth of the business enterprise, unless they are either participating or convertible into common or other participating stock, emphasis is accordingly placed on the current and future income yield by way of cash flow through dividends and/or redemptions. Some preferred stock may pay dividends into perpetuity (perpetual preferreds or “perpetuities”) or may have a maturity (redemption) date. Some classes of preferred stock may provide the holder the right to require the redemption thereof upon demand (“retractable”

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(1) While classified as “fixed-income” securities, the dividend rate may be specified as a fixed rate, an adjustable rate or a variable rate.

preferred shares, which are typically used in Canadian income tax and estate planning, as well as in reorganizing corporate share capital for employee-incentive purposes).²

Preferred Stock Features

Apart from the basic rights, there are a number of possible additional features or attributes that can, *individually or in combination*, attach to preferred stock:

- Redeemable (callable) at the option of the issuer;
- Cumulative dividends;
- Voting rights, which could be shared *pro rata* with, or superior to, the common stock, or be fractional;
- The right to vote on a “special resolution” to effect a fundamental corporate change;
- Sinking fund requirements providing for the redemption of the stock by the issuer;
- Convertibility, i.e., the holder’s right to convert the shares into common or participating shares, or into preferred stock of another class, usually exercisable during a specified period of time;
- Option or warrant attached, entitling the holder of preferred stock to purchase common stock at prices, in amounts, and during periods, stipulated;
- Retraction right (redemption or purchase of the stock at the shareholder’s option—much like a promissory demand note), which is typically used for Canadian tax planning purposes;
- Participation, i.e., once their basic, fixed dividend is paid, the preferreds may share in further distributions along with the common shares, either fully or with limitations, both as to dividends and upon dissolution;
- Exchanging (either into bonds of the issuer or into common stock of an affiliated entity);

(2) See, for example, R.M. Wise, “The Valuation of Preferred Shares Issued on a Section 85 Rollover”, *Canadian Tax Journal*, March/April 1984, Canadian Tax Foundation (Toronto), pp. 239 ff.

- A provision making the particular class of stock senior to all other preferred classes;
- The dividend, rather than being fixed, may be a function of the bank prime rate of interest (adjustable-rate or variable-rate preferred stock);
- There may be a premium paid on the shares upon dissolution of the corporation.

In the case of a closely held company (a family operating company or holding company), these features or attributes are often dictated by income tax, estate-planning and/or financing considerations.

Traditional preferred shares are “hybrids”, in that they may have some features that are similar to common shares and, in some cases, to corporate bonds.

If preferred stock is non-cumulative, the absence of the declaration of a dividend does not create a corporate debt to preferred stockholders. In certain cases, however, if the preferred dividends are not paid by the company for a specified period, the shares will become voting.³

Several of the foregoing preferred-stock features are outlined below.

Redemption

Virtually all preferred stock is redeemable at the option of the corporation. As noted above, if the stock is redeemable at the option of the shareholder, they are “retractable” — see below.

Public companies may have a call provision, which provides the issuer with financial flexibility should market interest rates decline substantially following the issuance of the preferred stock. The corporation can re-issue new securities at a (lower) market rate of return and therefore pay a reduced dividend on the preferreds.

Retraction Right

In Canada, retractable preferred shares are typically issued by closely held corporations in conjunction with estate freezing and/or income tax planning. The circumstances in which such

(3) Thereafter, until a specified dollar-amount of dividends is paid, the shareholders are entitled to receive notice of all meetings of shareholders and to one vote in respect of each share held.

shares are issued are generally in the context of a rollover in a “holding company freeze” or a “recapitalization freeze”.⁴

The retraction feature is, in effect, a put option in favour of the preferred shareholder.

The holding company freeze and the recapitalization freeze can be subject to adverse tax consequences, including ineffective price-adjustment clauses and third-party civil penalties imposed on the valuator⁵ if there are improper valuations.⁶

While the Canada Customs and Revenue Agency has never issued an *Information Circular* or made any pronouncements concerning the valuation of closely held preferred stock (other than officials making some comments at Canadian tax conferences), IRS *Revenue Ruling 83-120*,⁷ discusses the valuation of preferred stock for U.S. gift tax and other purposes in recapitalizing closely held businesses.

Voting Rights

While voting rights attaching to publicly traded preferred stock rarely provide sufficient voting power to influence corporate policy, voting preferreds of closely held corporations often do provide *de jure* control. In some cases, they are held along with voting common shares, such that together they can control both dividend policy and redemption policy. Non-voting preferred stock will fetch a higher per-share price if it is sold as part of a block with other voting shares so as to give the holder voting control of the company. In this connection, for example, the Tax Court of Canada stated:

“ ... we must keep in mind that those [preferred] shares can be sold on the market only together with the shares which give control of the issuing company. There is no market on which the preferred shares alone could be sold.”⁸

(4) For a detailed discussion as to the use of retractable preferred shares, see R.M. Wise, *supra* footnote 2, *op. cit.*

(5) See Canada Customs and Revenue Agency *Information Circular 01-1*, dated September 18, 2001, and R.M. Wise, “Canada’s New Penalties in Tax-Purpose Business Valuations”, *Business Valuation Review*, Vol. 21, No. 1, American Society of Appraisers, March 2002.

(6) R.M. Wise, “Valuations and Price-Adjustment Clauses”, *Report of Proceedings of the Fiftieth Tax Conference*, Canadian Tax Foundation (Toronto: October 25-28, 1998), pp. 33:1-33:50.

(7) 1983-2 C.B. 170 (for the purpose of amplifying *Revenue Ruling 59-60*, 1959-1 C.B. 237).

(8) *Marina Quebec Inc. v. Minister of National Revenue*, 1992 DTC 1392, at p. 1445.

Cumulative Dividend

Preferred stock of closely held corporations is generally non-cumulative (although there may be more than one class of preferred outstanding), unless the company issued preferred stock to raise outside financing and the financier insisted on such protection. The funds-provider may have also requested the corporation to include a sinking fund provision and/or conversion provision, or required the dividend to be reset periodically to prevailing market rates (variable- or adjustable-rate preferreds) so that the value of the stock would not vary significantly from its stated value.

A cumulative provision would not be necessary if the preferred-stock class has effective voting control of the corporation, or forms part of the controlling share block, and can therefore cause the company to declare and pay dividends on the shares and/or redeem them.

If the holder has control, and therefore can cause the payment of dividends on the stock and/or redemption, the cumulative feature is unnecessary. Similarly, if a minority shareholder has non-cumulative, “retractable” preferreds (and the company is financially able to pay the retraction price), the right to cumulative dividends may not be necessary for the preferred stock to hold its value.

Conversion Right

A conversion feature allows the preferred stockholder to unilaterally convert the stock into a fixed number of common shares. The conversion right resembles a call option. An investor in convertible preferreds would normally accept a lower dividend rate on the stock, with the conversion price being higher than the current price of the issuer’s common stock (i.e., “out-of-the-money”). Accordingly, if the value of the common stock increases, the preferreds’ value will also increase.

In effect, convertible preferred stock includes both a “debt” (fixed income) component and an equity (option) component:

- (a) The debt component relates to the dividend aspect, which provides the stockholder with a current income yield over and above that which could be realized by converting the preferred stock into common.
- (b) The equity component relates to the value of the common stock into which the preferred stock is convertible (calculated by multiplying the market price of the common by the number of common shares into which the preferred may be converted).

Convertible preferreds are valued at the higher of (a) their value as fixed-income securities and (b) their value as common stock.

Sinking Fund

In some situations, the issuer may be required to set aside funds for purposes of redeeming the preferred stock at a specified date or over a certain period, much like the sinking fund requirements for the retirement of bonds.

Participating Feature

The participating feature provides the preferred shareholder with the right to share in the issuer's net profits over and above the contractual dividend rate on the stock, e.g., share with the holders of common stock in dividend distributions on a particular basis after the preferred dividend has been paid. In other cases, the preferreds may be entitled to dividend distributions along with the common up to a specified dividend rate after which the preferred's entitlement to participate in earnings ceases.

Because the participating feature provides the holder with a portion of earnings distributions (through dividends), the valuation goes beyond a simple capitalization of the contractual dividend and in a manner similar to that with respect to common stock. As the additional value arising from the participating feature is a function of the anticipated further dividends on the stock, the valuator must therefore consider the dividend history of the common, as the participating dividend on the preferreds is paid when common dividends are paid, as well as the future prospects and growth of the enterprise.

Exchangeable Shares

The exchangeability feature provides the issuer with increased financial flexibility, because it can, in effect, convert non-tax deductible dividends into deductible interest expense to the corporation. In certain cases, the preferred stock of the issuer is exchangeable for common stock of another company (usually a related entity).

Exchangeable preferred stock also can provide the issuer with the option of exchanging the preferred issue into a subordinated bond or debenture having a substantially similar contractual coupon rate and maturity date. As the holder of exchangeable preferreds might become a

bondholder, and then subject to less favorable tax treatment on the income yield (interest), the valuation of exchangeable preferreds must reflect this potential disadvantage.

Adjustable (Variable) Dividend Rate

Rather than paying a fixed cash dividend, adjustable-rate preferreds provide for the dividend rate to be tied to the bank prime rate of interest and adjusted periodically, usually quarterly. This affords the holder certain stability with respect to the market value of the shares. Regard must be had to the difference between the basis for adjusting the private-company's preferred dividend and the publicly traded guideline preferreds in addition to the earnings protection and asset protection (liquidation preference) discussed below.

VALUATION METHODOLOGY

The key value-driver of traditional preferred stock is the future dividend stream, discounted at the required rate of return, considering the degree of certainty in receiving the dividends or, in the case of retractable preferreds, receiving the "retraction amount" upon the request of the holder.

A recent example of a preferred stock's price being specifically sensitive to dividends is when Ivaco Inc., a major publicly traded Canadian steel-product company with several plants in Canada and the U.S., reported its results for the first quarter ended March 31, 2003, stating that the company had to implement aggressive cost-cutting and cash-conservation measures:

"Accordingly, as part of these measures the Board of Directors has decided not to declare dividends on any of the Company's Preferred Shares and Second Preferred Shares which normally would have been declared at this time and would otherwise be payable on July 1, 2003. ... Also, in accordance with the share conditions attached to the shares the Company will not be in a position to purchase or redeem any of these shares ... nor will it be able to redeem any Second Preferred Shares, Series 5, tendered for redemption while dividends are in arrears."⁹

The trading price on the Toronto Stock Exchange of Ivaco's Preferred Shares tumbled overnight (between May 14 and May 15, 2003) by 46%!

(9) Ivaco Inc. Press Release, May 14, 2003.

Simple Valuation Formula

Traditional preferred stock is valued in a manner similar to traditional corporate bonds or debentures (assuming substantially comparable risk). Certain valuation “formulae” have been developed, which are outlined below.

The simple valuation formula for traditional preferred stock is expressed as follows:

$$\frac{\text{Annual Dividend Payments}}{\text{Required Rate of Return}}$$

In certain cases, dividend discount models may be appropriate. These consider the cash flows accruing to the investor in the form of dividends and the timing of the dividends. Consequently, the dividend discount model would be used to determine an *expected value* of the preferreds.

While the discount rate applied in the dividend discount model is a function of market rates of interest, it also contains a risk component arising from the inability to accurately predict future cash flows. This risk may result from such fundamentals as the company’s underlying financial condition and earning power. (See below: “Issue-Specific Risk” and “Company-Specific Risk”.)

Dividend Discount Model

If preferreds are redeemable and not convertible, their value may be expressed as follows:

$$\text{Value} = \sum_{t=1}^n \frac{C_t}{(1+k)^t}$$

where:

- C_t = Cash flow (including redemption price and dividends) generated in the future period t .
- t = Period when cash flows are generated.
- k = Required rate of return at which cash flows are to be discounted back to the present.
- n = Number of periods until redemption.

Redeemable preferred stock is valued as if it were non-redeemable when the stated dividend rate is below the current market rate for a comparable issue (because the issuer will not redeem preferreds having a dividend rate substantially below the market rate).

Assessment of Preferred Stock Risk

Because the anticipated cash flows (dividends or possible redemptions) are contractual, the valuation will involve an assessment of risk, expressed as a required rate of return, which, when used to discount the anticipated cash flows, will yield fair market value. Hence, in assessing the risk, two specific components must be considered:

- (a) *Issue-specific risk* (inherent in the particular class of preferred stock being valued), in particular the specific attributes of the stock; and
- (b) *Company-specific risk* (relating to the issuer itself).

Issue-Specific Risk

Whether the yield on the preferred stock supports a valuation of the stock at its stated value partly depends on the adequacy of the dividend rate; this, in turn, is determined by comparing the subject's dividend rate with that of high-grade, publicly traded, "guideline" (benchmark) preferred stock. Also, if the interest rate charged by arm's length lenders on the corporation's debt is higher than the rate they charge their most creditworthy borrowers, then the required yield on the preferreds should be correspondingly higher than the yield on high-quality guideline preferreds.

Company-Specific Risk

Company-specific risk relates to the ability of the issuer to meet its dividend requirements and redemption (or retraction) commitments and to provide for the preferred stock's liquidation preference in the event of the dissolution or liquidation.

Company-specific risk contains two components:

- (a) *Financial risk*, which is a function of the company's capital structure (debt versus equity, based on economic characteristics as opposed to classification on the company's balance sheet); and
- (b) *Operating risk*, which relates to the future operating performance of the business (and includes cost structure, cyclicalities, product demand, level of fixed overhead, product and plant obsolescence, capital intensity, etc.).

Comparisons are made with guideline companies having publicly traded preferred stock.

In analyzing the company-specific risk to assess the issuer's capacity to meet its preferred-dividend requisites, two factors are considered:

- (a) Earnings protection, and
- (b) Asset protection.

Earnings Protection

The best measure for assessing risk with respect to future preferred dividends is the Earnings-Coverage ratio (also referred to as the Fixed-Charges Coverage Ratio). A high ratio indicates less risk of a missed dividend and, therefore, the stockholder's required rate of return is lower.

Because the calculation of the ratio is performed as of a specific point in time, the financial data of cyclical businesses might not provide a long-term risk assessment of future dividends.

Maintainable earning power is measured by analyzing the variability of the return on total invested capital, apart from financial leverage considerations. The company's worst fiscal year is examined relative to the average of the immediately preceding three years (and also to total senior claims outstanding during such average period). For example, the Capitalization Ratio (see below) measures the company's vulnerability and leverage position in cyclical downturns. Earnings levels and maintainability are therefore critical factors.

The basic ratios that are analyzed to assess preferred-dividend risk are:

- ***Fixed-Charges Coverage Ratio***

$$\frac{EBIT}{i + [(preferred\ dividends) \div (i - t)]}$$

where:

i = interest expense.

t = the effective income tax rate of the corporation.

Earnings are before non-recurring and extraordinary items and before preferred dividends. Preferred dividends (being after-tax) are converted to a pre-tax basis because they are not tax-deductible to the issuer.

- ***Cash Flow to Long-Term Debt Ratio***

$$\frac{Net\ income + non-cash\ charges}{Long-term\ debt}$$

Non-cash charges include depreciation, depletion and deferred income taxes.

- ***Capitalization Ratio***

$$\frac{Total\ debt + Liquidation\ value\ of\ outstanding\ preferred\ stock}{Total\ debt + Total\ equity}$$

- ***Return on Total Capital Ratio***

$$\frac{Pre-tax\ income + Interest\ expense}{Long-term\ debt + Total\ equity}$$

Asset Protection

In a liquidation, preferred stock ranks after the claims of bondholders but before any proceeds may be distributed to common stockholders. When there is a high debt/equity ratio, preferred stock is subject to greater risk. For the preferred stockholder, the greater the total debt relative to common equity, the less protection and, accordingly, the more vulnerable the preferred dividend should there be a decrease in operating cash flow.

“Liquidation preference is the protection afforded the preferred stockholder if the company were to liquidate, or redeem retractable shares upon the request of the stockholder. Risk relating to liquidation preference is measured by the ratio of (a) the excess of the market value of the assets over the market value of the liabilities to (b) the aggregate liquidation value of the preferreds. To determine adequacy of coverage, the protection ratio is measured against that for high-quality, publicly traded preferreds.

As most investors in publicly traded preferreds perceive the company as a going-concern, liquidation preference is not as critical a factor as dividend coverage. However, when valuing *retractable* preferred shares of a closely held company, the ability of the company to pay the redemption amount upon request is critical.

Guideline Publicly Traded Preferreds

The valuation of closely held preferred stock involves a comparison of the yield on the shares with that of the group of guideline publicly traded preferreds having substantially similar share attributes, but also considering issue-specific risk and company-specific risk.

Moody’s and Standard & Poor’s rate publicly traded U.S. preferred stock by category based on risk profile.¹⁰

After comparing the respective ratios for the closely held and guideline public companies, the publicly traded preferreds are grouped by rating category. Based on the calculation of the dividend and liquidation preference ratios, the dividend yields for each preferred issue are averaged for each rating category.

An appropriate rate of return (yield) is selected for the subject closely held preferreds, considering the indicated yields of the most applicable rating category of the guideline preferreds.

(10) *Standard & Poor’s Stock Guide and Corporate Ratings Criteria* (New York).

The interest coverage and asset coverage ratios for the subject shares and the guideline shares are compared. The respective yields for each issue may be corroborated by the average yield listed by the rating service for each rating category.

The subject's relevant valuation ratios are therefore measured against those of the publicly traded "guideline" preferreds. The greater the comparative risk attached to the closely held preferreds *vis-à-vis* the publicly traded preferreds, the higher the rate of return (dividend yield) required by an investor.

Marketability Discount on Closely Held Preferreds

Preferred stock of a closely held company may be subject to a marketability discount if:

- (a) there is no retraction feature;
- (b) the holder does not control the company;
- (c) there is no "put" provision for the stock in the shareholders' buy/sell agreement (if any);
or
- (d) there are restrictions on transferability, pursuant to corporate law and/or agreements among the company's shareholders.

However, as noted earlier, even if the stock is retractable, such feature provides liquidity only if the issuer has the financial capacity to redeem the stock when the stockholder makes such a request.

The marketability discount applicable to *preferred stock* differs from that *vis-à-vis* closely held *common stock*. The holder of preferred stock is primarily interested in the cash flow generated by the annual dividend payments, whereas the holder of common stock considers the return to be in the form of dividends and/or appreciation in the value of the stock. However, for the common stock to realize its appreciated value, the stockholder must actually sell the stock. As minority common stock of a closely held company is illiquid and often subject to restrictions as to transferability, it can suffer a substantial marketability discount (from its minority-discounted value). Preferred stock would generally suffer a much smaller discount because there is a cash return (dividends) during the holding period, which is a key factor in quantifying such discount.

The discount is applied by reducing the value of the subject preferreds by a percentage discount, or, alternatively, by increasing the required dividend yield on the stock.

SUMMARY

To the holder, preferred stock falls between debt and common stock in legal ranking, investment attributes and financial risk. As with the valuation of common stock, careful consideration must be given to all of the factors that would have an impact on the preferreds as an investment. Judgment, coupled with an in-depth quantitative and qualitative analysis, must be applied in determining the fair market value of closely held preferred stock, particularly when the holder is not part of the controlling group.