CONVERTIBLE PREFERRED STOCK
AS A FINANCIAL TOOL

BY
GARY D. TALLMAN

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The objective of this paper is to provide the reader with a comprehensive view of convertible preferred stocks and the opportunities and dangers that they pose for the issuing corporation and the investing public. This paper will view the attributes of the convertible preferred stock from the vantage point of the issuer, the purchaser, and the general public. We will first concern ourselves with the definition of the convertible preferred stock, a little of the history of its use, and its characteristics.

What Is A Convertible Preferred Stock?

Convertible preferred stock is a hybrid security in the world of corporate finance. Basically, there are two groups that can lay claim to the assets of the corporation—the creditors and the owners. The creditors are represented in the capitalization of the company by long-term loans to the company in the form of bonds or debentures. The owners' equity is represented by stocks. Equity stocks may be further subdivided into two basic forms. One form is called common or capital stock and has a residual claim against the assets of the corporation after all other interests have been satisfied. The other basic form of equity stock has preference over the common stock, and it is called preferred stock. Preferred stock generally has preference over the
common stock for dividends and for the assets of the corporation in case of liquidation; but in any case, its preference is junior to that of the creditors of the corporation.

A convertible preferred stock is a hybrid version of the regular preferred stock. It has a preference for the assets of the company. In addition, at the holder's option, it may be converted into some other security of the company or into other property of value. Generally, convertible preferreds are convertible into the common stock of the issuing corporation, although this is not always the case.

As an example, in the early 1900's, a 7% preferred stock was offered for sale at $10 per share. Shares of this preferred stock were convertible into a fully paid funeral, the quality of which was dependent on the number of shares converted.¹ No mention was made of whether or not the owner had to personally present the shares for conversion.

The convertible security has been used in corporate finance for some time and first appeared in financial literature in the early part of the eighteenth century.² The use of convertible preferreds has continued to the present day and, due to some special circumstances and advantages, has increased in usage both numerically and proportionately.

On December 31, 1960, there were 68 convertible preferreds listed on the New York Stock Exchange. By June 30,

1966, there were 113 convertible preferreds listed on the Exchange. During this same time span the number of "straight" preferred issues listed on the New York Stock Exchange decreased from 391 to 251.¹

The characteristics of convertible preferreds are quite similar to those of straight preferreds, although they generally contain fewer protective provisions that have the affect of restricting the actions of the issuing company than do the straight preferreds.

The author of this paper made a survey of recent issues of convertible preferred stocks to determine what provisions they contained. The survey covered fifty issues of convertible preferred stocks in three industrial classifications. The convertible preferred stocks included were all issued in the last five years, were issued by corporations incorporated under the laws of the United States or a state of the United States, were listed in the 1967 issue of Moody's Industrial Manual, Moody's Public Utility Manual, or Moody's Transportation Manual, and each issue had an aggregate value in excess of $100,000. The survey actually included fourteen public utility company issues, six transportation company issues and thirty industrial company issues. All issues that met the criteria in the public utility and transportation categories were included in the survey. In the industrial category only about one-third of

the possible issues were included because it was felt that this was a large enough sample to determine the characteristics of the convertible preferred securities issued by industrial companies.

The criteria described above were utilized for the following reasons. Only those issued in the last five years were included because this paper is concerned primarily with how convertible preferreds are being utilized under present economic conditions, and issues outstanding for a longer period may contain unusual provisions that would make the security a straight preferred in fact, if not in name. Only domestic issues were included because securities laws and practices vary so greatly from country to country that it would be far beyond the scope of this paper to attempt to describe the use of convertibles in such varied circumstances. Issues with an aggregate value of less than $100,000 were not included because the smaller issues are generally not publicly held and are issued to accomplish a specific task in a specific environment.

The above survey will be complemented, where possible, from surveys conducted by C. James Pilcher covering the period 1933 to 1952 prepared in conjunction with his doctoral dissertation entitled "Convertible Bonds and Preferred Stocks: An Analysis and Evaluation of Their Role as Capital-Raising Instruments".

Conversion Privilege

The first characteristic to be considered is the
conversion privilege which is the characteristic that differentiates the convertible preferred from the straight preferred. As was mentioned earlier, the privilege usually allows the holder to convert into common stock of the issuer. Generally speaking, the holder can convert at his option with no restrictions by the issuing company. Of the fifty securities surveyed only three issues or 6% of the total issues surveyed contained a conversion privilege that was inoperative for a period of time immediately after issuance.

The conversion privilege can be described in two ways—as a conversion ratio or a conversion price. The easiest method of explaining this difference is through the use of an example. Assume that "X" corporation issues a convertible preferred stock with a par value of $100 per share when its common stock is selling for $45 per share. The conversion privilege states that the holder of the convertible preferred can convert into common stock at a conversion price of $50 per share. That is, he can convert $50 of par value of the convertible preferred stock for one share of common stock. To determine the conversion ratio divide the par value of the preferred by the conversion price. In this example divide 100 by 50 to obtain a conversion ratio of 2.

The issuer of a convertible preferred can write conversion rights in such a manner as to encourage a holder to convert his securities before a date predetermined by the
issuer. This is accomplished by creating a stepped conversion price or ratio that becomes less advantageous to the holder as time passes. An example of this type of conversion right is found in Texas Eastern Transmission Corporation's issue of 5.125% Subordinate Convertible Series issued in 1961. The provision used reads as follows:

"The 5.125% Subordinate Convertible Series is convertible into Common Stock at $20.00 per share on or before August 1, 1966, at $22.50 per share thereafter and on or before August 1, 1971 and at $25.00 per share thereafter and on or before August 1, 1976, subject to earlier redemption."1

The conversion right of the holder is usually protected by a provision against dilution. Dilution occurs if the issuing corporation has a stock dividend or split, or if the issuer sells additional shares of common stock at a price below the conversion price. Take the case of a stock split as an example of how a conversion privilege can become diluted.

Assume that the holder of a convertible preferred issue has no protection against dilution and has the right to convert into common at a conversion price of $50 per share. The common stock is presently selling at $48 per share and the issuing company declares a 2-for-1 stock split. After the split the common stock will be selling at $24 per share, but the conversion price will still be $50

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1 Texas Eastern Transmission Corporation, Prospectus covering $30,000,000 5 3/8% Debenture due August 1, 1981; 200,000 Shares Preferred Stock; 5.125% Subordinate Convertible Series, filed with the Securities Exchange Commission August 2, 1961, p. 1.
per share. The convertible preferred's conversion privilege has lost any value it had. If the convertible preferred holder had been protected against dilution, his conversion price after the stock split would have been $25 per share, and he would have lost none of the value of his conversion right.

Many of the anti-dilution provisions found in convertible preferreds stipulate that no adjustment will be made until a specific dollar effect on the conversion price has been reached. This allows the issuing company to make minor stock dividends without adjusting the conversion price. Of the fifty securities surveyed, all had protection against dilution specified in their conversion privilege except for five issues or 10% of those studied. The issues that did not contain protection against dilution of their conversion privilege were generally small issues used in acquisitions and were not widely distributed. An example of an anti-dilution provision can be found in a prospectus filed by the Indianapolis Power & Light Company covering its Convertible 6 1/4% Cumulative Preferred Stock and reads as follows:

"The conversion price is subject to adjustment if the Company issues shares of Common Stock for less than the conversion price then in effect, or as a stock dividend, or subdivides or combines its Common Stock, or in the case of a capital reorganization, reclassification of capital stock, or consolidation or merger, but not with respect to the issuance of Common Stock which may be issued exclusively to officers or employees of the Company.
pursuant to any employee's compensation or incentive plan. No such adjustment will be made unless it amounts to $50 or more."¹

The above example of an anti-dilution provision makes use of what is known as a conversion price formula as opposed to a market price formula in determining the necessary dilution adjustment. The conversion price formula is the stronger of the two and demands adjustment in the conversion price upon any sale of common stock below the conversion price. The market price formula only requires adjustment in the conversion price if common stock is sold at a price below the then current market price of the common stock. The market price formula is based on the concept that the holder of the convertible security is in the same position as the common stockholder and should be subject to the same risks and benefits. The conversion price formula is based on the concept that the convertible security is senior to the common stock as shown by its claim on the common stock at the conversion price and this conversion price must be protected if the rights of the holder of the convertible security are to be protected.

There is one other provision that was included in the conversion right of all of the issues that were surveyed. This provision concerns the payment of accrued dividends on the convertible preferred; and if the investor is

not aware of the existence and effect of this provision, it could prove costly to him. The provision states that there will be no adjustment for unpaid preferred dividends made upon conversion of the preferred into common stock. The effect of this provision can be illustrated by assuming a 4% convertible preferred stock, par value $100 per share, and dividends payable March 1, June 1, September 1, and December 1. If the holder were to convert on May 1 to common stock he would be entitled to no dividends. If the holder held the preferred stock for one more month he would be entitled to three months' dividend. It is obvious that the time to convert is as soon as possible after the preferred dividend record date unless there is wide fluctuation in the price of the common stock.

**Voting Rights**

The second characteristic of the convertible preferred to be considered is the voting right of the security. The voting right will take on prime importance in a later discussion in this paper concerning the issuance of convertible preferreds for use in acquisitions where a "pooling of interests" concept is being employed.

A convertible preferred can have one or both of two general types of voting rights. Since it is a form of equity capital and since it is convertible into common stock, it may have a vote equal with the common stock of the corporation. Or, looking at the preference status of the stock, it may have the right to vote on certain issues as a
class or be allowed to elect as a class a specified number of directors on the Board of Directors. The term "voting as a class" means that the members of a grouping such as all of the preferred stockholders of a company have the right to decide a question or issue by vote irrespective of the votes of persons outside of the grouping such as common stockholders.

Reference is made to Table I in the Appendix of this paper which summarizes the findings of the survey of fifty issues concerning the voting provisions used. This table gives both actual number of issues containing the provision and the percentage of issues containing the provision by industry and in total. Three specific voting rights were surveyed. The first is the right of the convertible preferred holders to vote on matters concerning the corporation on an equal basis with the common stock. The second is the right of the convertible preferred holders to vote as a class to authorize the issuance of a series of stock with equal or prior rights as compared to the convertible preferred. The third is the right of the convertible preferred holders voting as a class to elect members to the Board of Directors in the event that a specified number of preferred dividend payments are in arrears.

Table I shows that 35 issues or 70% of those surveyed contained voting rights on par with the voting rights of the common stock into which they are convertible. This does not necessarily mean that the convertible preferred
holder has a proportionate voting right with the common stock. The point here is that a holder of a convertible preferred stock with a par value of $100 per share and convertible into four shares of common stock which are selling for $25 per share may be entitled to one vote per share just as is the holder of the common stock. The convertible preferred holder, however, has four times the investment in the corporation that the common stockholder has who has the same voting power.

Table I also shows that 37 of the issues or 74% of those surveyed contained a provision allowing the convertible preferred stockholders, voting as a class, to approve the issuance of stock with prior or equal rights to dividends or upon liquidation to the assets of the corporation. This voting right is given to the holder as a form of protection so that the company does not reduce the position of the holders by issuing securities with prior rights.

Table I shows that 38 issues or 76% of those surveyed contained a provision allowing the convertible preferred holders voting as a class to elect a specified number of directors of the corporation upon default of generally six dividend payments. A determining factor of whether or not an issue contains this provision is whether or not it is to be listed on the New York Stock Exchange. The Exchange requires that a preferred stock contain this provision before it is accepted for listing.

This voting provision was the only one that showed
a significant variation in usage from one industry classification to another. Among the 30 industrial issues surveyed 83% of them contained such a provision. Of the 14 public utility issues surveyed, 50% of them contained such a provision. Of the 6 transportation issues that met the criteria and were surveyed, 100% of them contained the provision. If these percentages are compared against the percentage of those issued for the purpose of acquisition or mergers, as shown in Table II of the Appendix, it will be seen that the total and industry percentages are identical. An issue by issue comparison shows that there is not, in fact, an identical relationship between the purpose of issue and the inclusion of the right to elect directors of the corporation as a class.

All of the convertible preferred stocks surveyed also contain the provision, in compliance with securities' regulations, that none of the voting provisions of the stock may be changed without the consent of a majority of the holders of that class of stock.

An example of a voting provision that does not permit the holder of the convertible preferred to vote with the common stockholders on corporate matters can be found in the prospectus of the Consolidated Edison Company of New York, Inc. covering its issue of cumulative preference stock. The provision is as follows:

"The Preference Stock has no right to vote except as otherwise required by law and except that, without the consent of two-thirds of the Cumulative Preference Stock, the Company may not:
"(a) create or authorize any kind of stock ranking prior to the Cumulative Preference Stock with respect to the payment of dividends or upon the dissolution, liquidation or winding up of the Company, whether voluntary or involuntary, or create or authorize any obligation or securities convertible into shares of any such kind of stock; or

"(b) amend, alter, change or repeal any of the express terms of the Cumulative Preference Stock so as to affect the holders thereof adversely.

"Under New York law the Company may not, without the consent of a majority of the Preference Stock, amend, alter, change or repeal any of the express terms of the preference Stock if such amendment, alteration, change or repeal would affect adversely the Preference Stock but not all of the Cumulative Preference Stock at the time outstanding."¹

An example of a voting provision that does permit the convertible preferred holder to vote with the common stockholder can be found in the prospectus covering the issue of Atlantic Richfield Company convertible preference stock offered in exchange for the common stock of Sinclair Oil Corporation. The provision is worded as follows:

"The holders of Preference and Common Stock are entitled to one vote per share and to vote cumulatively for directors. The Preference Stock and the Common Stock vote together as one class, except as to certain matters which will require a vote by the holders of Preference Stock as a separate class as stated below. The holders of Preferred Stock have no voting rights except as provided by law or in the Articles of Incorporation.

"The Articles of Incorporation provide that if Atlantic Richfield shall be in default with respect to dividends on the Preference Stock in an amount equal to six quarterly dividends, the number of directors of Atlantic Richfield shall be increased by two at the first annual meeting thereafter, and

at such meeting and at each subsequent annual meet-
ing until all dividends on the Preference Stock
shall have been paid in full, the holders of Prefer-
ence Stock shall have the right, voting as a class,
to elect such two additional directors. The Arti-
cles contain an identical provision with respect to
the Preferred Stock.

"The Articles provide that Atlantic Richfield
shall not without the assent of the holders of two-
thirds of the then outstanding shares of Preference
Stock (a) change any of the terms of the Preference
Stock adversely to the holders, or (b) authorize
any prior ranking stock; and that Atlantic Rich-
field shall not without the assent of the holders
of a majority of the then outstanding shares of
Preference Stock (1) authorize any additional
Preference Stock or stock on a parity with it; (2)
sell, lease, or convey all or substantially all of
the property or business of Atlantic Richfield; or
(3) merge or consolidate unless the surviving or
resulting corporation will have no stock authorized
or outstanding ranking prior to or on a parity with
the Preference Stock except stock of Atlantic Rich-
field authorized or outstanding immediately before
the merger or consolidation or stock of the sur-
viving or resulting corporation issued on conver-
sion or in exchange therefor."¹

Call Provisions

The next characteristic of convertible preferreds
we will study deals with the call provision. This provision
is used as a form of protection for the issuing company and
allows the company to force the holders of the convertible
preferred stock to surrender it for a cash payment. The is-
suing company may wish to exercise this provision when the
market price of the common stock is higher than the conver-
sion price stated in the convertible preferred.

An example will show more clearly why a company may

¹Atlantic Richfield Company, Prospectus covering $3
Cumulative Convertible Preference Stock, filed with the Se-
wish to force conversion. Assume that an investor holds a convertible preferred with a par value of $50 per share that is convertible into two shares of common at $30 per share. The common is selling at $40 per share. This situation is detrimental to the interests of the common stockholder if it is allowed to continue. The convertible preferred holder invested in his security to obtain regular dividend payments plus have the opportunity of sharing in gains with the common stockholder from a rise of $5 per share in the price of the common stock. The price of the common is now $40 per share and the convertible preferred holder still receives his preferred dividend and has the opportunity to share with the common stockholders any further price increase rather than the $5 per share increase he was willing to accept when he purchased the security. Any new investors wishing to invest in the company would be well advised to buy the convertible preferred with its assured dividend and its participation in any further rise in the price of the common rather than the common stock itself. The threat of the conversion of the convertible preferred which would bring new common shares onto the market also tends to be detrimental to the price of the common.

The issuing company protects itself from such a position by including a call or redemption provision in its security. Of the fifty issues surveyed for this paper, all had a call provision of some type. Many of the issues contained the stipulation that they would be non-callable for a
specified length of time. This stipulation is used as a marketing aid to make the security more acceptable to investors. Obviously, the investor would wish to have no call provision at all so that he would have the opportunity of attaining a preferred position when the price of common exceeded the conversion price. Of the fifty issues surveyed, 33 of them or 66% of the issues contained a time period during which the convertible preferred was non-callable. Five years was the typical time period the issue was non-callable.

The cash payment due when the issue is called is generally the par or stated value plus accrued dividends and a call premium. The call premium is most frequently equal to about one year's dividend originally and declines gradually thereafter to the par or stated value of the security.

An example of a call provision without a period in which it is non-callable may be found in the prospectus of Long Island Lighting Company covering its issue of convertible preferred. The provision reads as follows:

"Redemption Provisions: At the option of the Company, any or all of the outstanding Preferred Stock may be redeemed or refunded at any time on not less than 30 days' notice at the applicable redemption prices fixed for the respective series, plus accrued dividends (see Note 3 to Financial Statements). Except for provisions requiring ratable dividend and liquidation payments on shares of Preferred Stock, the Company's charter and existing statutes do not prohibit the redemption or repurchase of Preferred Stock by reason of any default in dividends or sinking fund payments, if any. Each share of Convertible Preferred Stock is redeemable at $105 through November 30, 1968, $104 thereafter through November 30, 1969, $103 thereafter through November 30,
1970, $102 thereafter through November 30, 1971, $101 thereafter through November 30, 1972, and $100 thereafter, in each case plus accrued dividends."

An example of a call provision that contains a period during which the security is non-callable may be found in an issue of convertible preferred of Transamerica Corporation. The provision reads as follows:

"Redemption: On or after, but not before, April 1, 1975, in the case of the $4.80 Convertible Preferred Stock, and at any time in the case of the 4 1/2% series, such preferred stock may be redeemed by Transamerica, at its option, in whole or in part, at any time or times, on not less than 30 days' notice, at a redemption price of $104.80 per share in the case of the $4.80 Convertible Preferred Stock and $105 per share in the case of the 4 1/2% series, together, in each case, with an amount equal to all accrued and unpaid dividends thereon to the date of redemption."2

Liquidation Provisions

The liquidation provision is included in convertible preferred issues as a form of protection for the holder of the security in case the company liquidates or winds up its business. This provision is included because of the preferred nature of the security when compared to common stock. The provision entitles the holder to receive a specified payment before holders of common stock receive any payment. Generally, there are two types of payment stated


depending on whether the liquidation is voluntary or involuntary. In the case of a voluntary liquidation, the holder is usually entitled to a payment equal to the call price of the security. If the liquidation is involuntary, the payment is equal to the par or stated value of the security. In either case, the holder is usually entitled to all accrued and unpaid dividends on his convertible preferred stock.

An example of such a provision can be found in an issue of convertible preferred by Central Louisiana Electric Company, Inc. The provision reads as follows:

"After payment or provision for the payment of all creditors of the Company, the holders of Preferred Stock are entitled to receive pro rata, in the event of any liquidation of the Company, the preferential amounts fixed for the respective series, together with accrued and unpaid dividends. The Convertible Preferred Stock is entitled to the then applicable redemption price for Convertible Preferred Stock in the case of a voluntary liquidation, and in the event of an involuntary liquidation to $100 per share, plus, in either case, all accrued and unpaid dividends to the date payment is made available."

Other Provisions

There are other provisions that occasionally appear in convertible preferred issues that are restrictive in character and beneficial to the holder. The most frequently used of these provisions is the restriction on common stock dividends. This provision prevents the issuing company from

paying dividends on its common stock to the extent that it might impair the company's ability to pay dividends on the convertible preferred. Of the fifty issues surveyed, 19 issues or 38% had dividend restrictions of some type.

An example of this restriction can be found in the issue by Central Louisiana Electric Company, Inc. referred to earlier. The provision reads as follows:

"So long as any shares of Preferred Stock are outstanding, the total amounts paid or distributed on Common Stock and the total amounts applied to the purchase or other acquisition for value of Common Stock are restricted (a) to not more than 50% of the net income available for dividends on Common Stock for twelve consecutive calendar months within the fifteen months immediately preceding such payment, when the ratio of the Common Stock equity to total capitalization (as such terms are defined in the Articles of Incorporation), at the end of such twelve months' period, is less than 20%, and (b) to not more than 75% of such net income when such ratio is 20% or more but less than 25%. At any time when such ratio is 25% or more, such payments shall not be restricted except that the Company may not make any such payment (other than as permitted by (a) and (b) above) which would reduce such ratio below 25%. The foregoing restrictions do not apply to dividends payable in Common Stock."

A second restrictive provision that occasionally appears is a restriction on additional debt of the company. This provision is more generally found in straight preferred stocks and is seldom used in convertible preferreds. Of the fifty issues surveyed, only two issues or 4% contained any provision restricting the issuance of debt. The intent of such a provision is to prevent the company from issuing debt which has a claim to the company's assets for the payment of interest and principal prior to the convertible preferred.

1Ibid. p. 20.
A third provision is protective in character in that it forces the company to improve the security position of the convertible preferred through an investment of company assets. This provision provides for a sinking fund that annually retires a portion of the outstanding convertible preferred. Retiring a portion of the issue reduces the fixed dividend payments that the company must meet and leaves more current earnings for use in meeting the dividends on the remaining convertible preferred. The use of this provision has been declining steadily over the years, possibly because more of the current issues have been issued with the intent that they would convert rather than be redeemed. A sample of 73 convertible preferreds sold in the period 1948-1952 showed that 46.5% did not specify a sinking fund. Of the fifty issues surveyed for this paper, 47 issues or 94% of those surveyed did not contain a sinking fund provision.

**Why Is It Utilized By Issuers?**

To this point we have concentrated on what a convertible preferred stock is and what provisions it may contain. In other words, we have described the physical aspects of a tool of finance. Now, we must show how this tool may be used under our current business and economic conditions to accomplish a goal. There are two goals which can be

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accomplished through the use of convertible preferreds. One is to raise capital for the issuing firm and the other is to acquire the operations of another firm.

Table III in the Appendix of this paper summarizes the purpose of issuance for the fifty issues surveyed for this paper. The information is shown in total and broken down into three industry classifications in accordance with Moody's Manuals. The table shows that 76% of the total issues were issued for the purpose of acquiring other companies. An industry breakdown shows that 83% of industrial, 50% of utility and 100% of transportation issues were for the purpose of acquisitions. This compares with another survey that was made of all convertible preferred stocks listed on the New York Stock Exchange for the eighteen months' period from January 1, 1965 to June 30, 1966. This survey covered 44 issues of which 82% were issued in connection with acquisitions.1

The remainder of this section will deal in detail with the two goals that can be accomplished through the issuance of convertible preferreds. The first goal to be reviewed is to raise capital.

**Raise Capital**

Arthur Stone Dewing made the statement that "the purpose of all convertible issues is to enable the corporation to obtain for an issue of securities a market price

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1 Hollender, 29.
greater than would be possible without the convertible feature.¹ This is a true statement, but it needs further explanation to show the mechanics of how the market price for a security is increased through the use of a conversion privilege.

A convertible preferred stock can be sold in the market at a dividend cost to the issuer less than that obtainable on a straight preferred. Why is this so? This is so because a convertible preferred depends on two factors for its value and, therefore, appeals to a wider market than the straight preferred. The first factor is the investment value derived from the fixed dividend rate paid. The investment value appeals to the investor interested in a fixed income security. The second factor is the conversion value derived from the stock's right to convert to common stock. The conversion value appeals to the investor interested in the price appreciation potential of an equity security. Since the convertible preferred appeals to a wider market and its value to investors is not determined solely by its dividend rate, it may be sold at a dividend rate below that of the straight preferred.

The above argument shows why a convertible preferred can be sold at a dividend cost below that of straight preferred, but is there still a cost savings to the issuing

company when the preferred is converted to common stock? The answer is yes; and, in fact, one of the primary reasons for issuing convertible preferreds is to obtain a higher price for common stock than could be obtained in the current market.

Assume that a corporation's common stock is selling at $40 per share and that it issues a 5% convertible preferred stock at $100 per share that is convertible into two shares of common stock. In effect, instead of selling two shares of common stock at the current market price of $40 per share, the company has sold a dividend bearing right to subscribe to two shares of common stock at $50 per share.

There is obviously the cost to the company of the dividends on the convertible preferred when "selling" common stock in this manner. This cost is generally offset by several advantages. One advantage is that the common stock does not have to be underpriced when it is sold. If the current market is $40 per share for the common stock, it may have to be offered at something less, say $37 per share, to insure that it will all be sold. This reduction in price is necessary to offset the daily fluctuations in the price of the common and to counter the price effect of a new supply of the common stock on the market. If the market price were to slip below the offering price, there would be few investors interested in the new stock offer. Another advantage is that since the convertible security has a wider market than common stock, the underwriters handling the sale of
the securities will charge a lower underwriting fee to handle the sale.

A company that believes its stock is undervalued in the current market has the further advantage of selling its common stock at tomorrow's higher price. Some of the reasons that a company's common stock might be undervalued are as follows:

1. "A general cyclical stock market decline that sweeps all stock prices down, regardless of individual merit.

2. "A few recent years of poor company or industry earnings that are in process of being reversed but meanwhile have caused the common stock to sell at distress prices.

3. "The corporation is about to take off into a period of great expansion and earnings growth, and the market is likely to increase the multiple of earnings (or the price/earnings ratio) at which the stock sells."1

The following reason why it is to the issuers advantage to issue convertible preferred applies to the raising of capital and also to issuing convertible preferreds in acquisitions. The reason is to postpone dilution of the current stockholders' position in the company.

The most visible dilution of the original common stockholders' position is the reduction of earnings per share. Earnings per share are reduced because of a couple of factors, one being simply the greater number of shares outstanding. Another factor is that the proceeds from the sale will not

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immediately produce as great a return as the existing capital. There are various reasons why this is so. First, time is required to construct new facilities or otherwise productively invest the new funds. Until the new funds are productive, the new shares will have to share income with the old shares. Second, the new shares will be entitled to the same cash dividends as the old shares which will place a greater demand on the cash resources of the firm, thus diverting them from more productive use.

A third reason for dilution of earnings is the effect of leveraging. Firms in some sectors of the economy such as utilities are forced to leverage their companies in order to earn an attractive return on their common equity. Leverage, as the term is used here, is the practice of utilizing creditors' funds within the business to earn a return that is great enough to pay the creditor for the use of the funds and still provide additional earnings for the benefit of the stockholders of the company. When new equity funds are brought into the company, the degree of leverage declines and income per share tends to decline.

The use of convertible preferred stock rather than the direct sale of common stock will postpone and minimize the effect of the additional equity on earnings per share. Generally, the convertible preferred stock with its senior position to the common stock can be sold at a cost below that of the common as mentioned in an earlier section of this paper. As soon as the new funds are invested in the
company and are earning a return greater than the dividend rate on the convertible preferred, they will be making a positive contribution to the earnings available for the common stockholders.

There is yet another way in which convertible preferred will aid in at least the reporting of earnings per share figures if not in the absolute earnings per share of the company. This effect occurs because the use of the convertible preferred poses a reporting problem for the firm's accountants. Do you report earnings per share before conversion or after conversion of the preferred stock? The difference in the two choices can be very significant depending on the size of the issue in relation to the common stock outstanding.

In December, 1966, Opinion No. 9 of the Accounting Principles Board of the American Institute of Certified Public Accountants was issued in answer to this problem. The opinion states that two earnings per share figures should be reported if the reporting company has an issue of convertible securities of significant size outstanding. The first earnings per share figure is the conventional one which assumes that the convertible securities are not converted. The second is a pro forma earnings per share figure which assumes that the convertibles have been converted. When computing the pro forma earnings, the dividends on the convertible preferred stocks are added to earnings available for common stock and are then divided by the shares of common
stock that would be outstanding after conversion.

This method of reporting earnings per share is utilized to the point where the convertible preferred derives more than half of its worth from its conversion value whereupon it becomes a residual security. When it becomes a residual security, the earnings per share must be reported as if conversion had already taken place.¹ A later opinion classifies an issue of convertible securities as residual at the time of issuance if the terms of conversion are such as to result in an immediate and material dilution in pro forma earnings per share. A discussion of conversion value appears in a later section of this paper.

Another form of dilution the original common stockholder faces when new common stock is sold is the reduction in his proportionate vote in company affairs. Assume that a company has one million shares of common stock outstanding and decides to sell an additional five hundred thousand shares. If the current shareholder does not obtain any of the new shares, his vote in company affairs will be two-thirds of what it was before the issuance of the new shares. The use of convertible preferred stock will not stop this dilution of the current stockholders' voting right, but it may postpone it and lessen its impact when conversion actually takes place. The use of convertible preferred stock lessens the impact of the new common by requiring fewer new

shares of common to accomplish the objective. Assume that a value of $1,000,000 is to be given in securities of some type to acquire a company. If the common stock of the acquiring company were selling at $50 per share, it would require 20,000 shares to make the acquisition. Now assume that a $100 par or stated value convertible preferred stock could be issued that was convertible into 1.75 shares of common. It would require 10,000 shares of convertible preferred to obtain the required value of $1,000,000. The 10,000 shares of convertible preferred would only convert into 17,500 shares of common stock or 2,500 shares less than if common stock were used in the acquisition.

The postponement of dilution of voting rights can become critical in acquisitions because the use of a voting stock in an acquisition may bring a new, concentrated block of voting power into the company. A convertible preferred can lessen and postpone the utilization of this power to a later date.

This brings us to the second major goal convertible preferreds are used to attain, to acquire companies.

**Acquire Companies**

The United States businessman has moved strongly into the market for buying and selling going concerns. There are many reasons that prompt the purchase or sale of a going concern. The seller may decide to dispose of his business for profit reasons, to retire, to diversify his interests, or because of tax considerations. The purchaser
may be interested in growth and expansion, diversification, or alleviation of competitive pressures. Regardless of the reason, it is evident that the pace of new mergers and acquisitions is quick and becoming quicker. In the first six months of 1968 there were 20% more mergers than in the same time period in 1967.\(^1\) It is also evident from the statistics presented in Table II in the Appendix of this paper that convertible preferreds have played a strong role in many acquisitions.

For accounting purposes there are two categories of business combinations—purchases and pooling-of-interests. The accounting distinction between the two is as follows:

"For accounting purposes, a purchase may be described as a business combination of two or more corporations in which an important part of the ownership interests in the acquired corporation or corporations is eliminated or in which other factors requisite to a pooling of interests are not present. In contrast, a pooling of interests may be described for accounting purposes as a business combination of two or more corporations in which the holders of substantially all of the ownership interests in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituent corporations, either directly or through one or more subsidiaries, and in which certain other factors . . . are present."\(^2\)

The accounting treatment of an acquisition becomes of primary importance to both the purchaser and the seller.

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\(^2\)Committee on Accounting Procedure, American Institute of Certified Public Accountants, Business Combinations, Bulletin No. 48, January, 1957.
A detailed treatment of the accounting and tax theory that underlies the concepts of "tax free" acquisitions and pooling-of-interests are beyond the scope of this paper. Therefore, the following discussion of these concepts will be correct in the general form it is presented with the knowledge the the specific circumstances of a particular situation could make the general statements inapplicable.

The seller of a business is concerned that the transaction be treated "tax free" in the eyes of the Internal Revenue Service. In order to effect such a transaction for the seller, the purchaser must utilize securities, either voting or non-voting, as the medium of payment to the seller. The seller can enjoy a "tax free" transaction under either the purchase or pooling-of-interest approaches. A further definition of a "tax free" transaction must be made at this point to avoid misleading the reader. A "tax free" transaction does not avoid the payment of United States income taxes; it only postpones them until the receiver of the securities in the transaction sells them and realizes an income on the sale.

The real significance of the purchase or pooling-of-interest approaches becomes evident when we view the effect of the transaction on the purchaser. The purchaser is primarily interested in what effect the transaction will have on the reported results of his operations, more specifically his reported earnings per share. The importance of earnings per share is evident from the following quotations
from an accounting research study prepared for the American Institute of Certified Public Accountants.

"In fact, we (accountants) were told time and again in our field work that if earnings per share subsequent to the combination could not be maintained at a level at least equal to the earnings per share prior to the combination, the deal would not take place. For the management of the acquiring company this aspect of the combination is particularly important."¹

The study also suggests that "the unusual significance attached to earnings per share and the ramifications it has in the financial world are undisputed conditions which accountants must recognize."²

The purchase-of-assets approach to a business combination has the effect of temporarily decreasing the reported earnings of the acquiring company. The acquired assets are recorded at the fair value of the property acquired or the value of the securities issued whichever is more evident. Most frequently the value recorded is the value of the securities given and is assigned to tangible property, intangible property and to goodwill. The new value assigned to the tangible and intangible property is generally higher than the value the purchased property was recorded at on the seller's books.

Since the acquired property is recorded at a value


²Ibid. p. 95.
higher than that which it was carried on the seller's books, the resulting depreciation charges will be higher than those that the seller would have recorded had the sale not taken place. The portion of the value assigned to goodwill must be written off against earnings in periodic installments according to presently accepted principles of accounting. The increased depreciation charges in conjunction with the periodic write-off of goodwill combines to lower reported earnings per share.

The pooling-of-interests approach to a business combination generally has the effect of increasing reported earnings per share. Under this approach, the companies involved combine their financial positions to show a consolidated statement as though they had always been one company. The assets of the acquired company are shown at the value at which the selling company carried them on its books. The value of the selling company's common stock is removed, but the retained earnings are combined with the acquiring company's retained earnings. There is no goodwill recorded in this transaction. As compared to a purchase-of-assets transaction, the lack of goodwill write-offs and the lower depreciation charges on the lower recorded value of the acquired assets combine to produce lower charges against earnings available for common stock and, therefore, increases reported earnings per share. This increase in earnings is partially offset by increased income tax payments, but it still generally reflects a more favorable earnings per share figure.
than the purchase-of-assets method.

The reader must be warned once again that the above discussion was intended to be very general in nature. The conclusions drawn can easily be reversed when they are applied to any individual instance because of the complexity of the subject. The author's only defense lies in the aggregate.

It is apparent then that there are distinct advantages that accrue to the acquiring company when the pooling-of-interests approach to a business combination is utilized. The question now is what part convertible preferred stocks play in the pooling-of-interests approach to combinations.

If the pooling-of-interests approach is used, certain criteria should be met. One criteria is continuation in the same business of the resulting entity. Another criteria is the continuation of basically the same management. By far the most important criteria to be met is the continuation of the equity interest of the stockholders of the acquired company in the resulting company. This means that the stockholders of the acquired company generally must receive voting stock of some type in the surviving corporation in return for their investment in the acquired corporation.

The voting stock must be either common stock or a stock that has a voting right ranking equal to common stock. Convertible preferred stock lends itself well to use in this type of transaction. It has the attraction of a fixed income security, the possibility of participating in a rise in the
price of common stock and can have whatever provisions necessary to meet specific circumstances.

As mentioned above, one provision generally necessary for a pooling-of-interests is a voting right ranking equal to common. The advantage to be gained by the use of convertible preferred stock rather than common stock is that the convertible preferred holder does not have to receive a proportionate voting right as was discussed in an earlier portion of this paper. This becomes especially important if the stock of the acquired company is closely held. If the holders of the common stock of the acquired company are given common stock of the acquiring company, they will represent a significant voting power in the resulting organization.

Table III appearing in the appendix of this paper summarizes the findings of the survey of fifty issues of convertible preferreds with respect to their voting rights and categorizes the findings according to purpose of issue. With respect to issues containing voting rights ranking equal with common stock, 82% of those issued in connection with mergers or acquisitions contained such a right while only 67% of those issued to raise capital contained the right. This is some indication of the number of acquisitions and mergers that utilized the pooling-of-interests approach to combinations and, therefore, required the voting provision in the security used.

The use of convertible preferred stock can prove advantageous in acquisitions in yet another way; that is,
the dividend rate. If the acquired company has a high dividend pay out rate (per cent of earnings paid out in dividends) in comparison to the acquiring company, the sellers may be forced to take a dividend cut if common stock is the medium of purchase. If convertible preferred is used, the dividend rate can be set at a level equal to the seller's previous dividend rate, thus removing a possible objection to the acquisition.

There is another benefit attached to the use of convertible preferred that is helpful for the earnings per share of the acquiring company but may not be in the interests of the common stockholders. This is the leveraging effect of the convertible preferred itself. If the acquired business is producing earnings greater than the dividends on the convertible preferred, the excess earnings can be applied to earnings available for common stock, thus raising reported earnings per share. This could be detrimental to the common stockholder if the dividend rate on the convertible preferred is higher than that on the common stock it would convert into. The difference between the dividend rates is the cost to the common stockholder of not having the convertible preferred converted even though reported earnings per share would be lower if the stock were converted. One can argue that the common stock is selling at a higher price because of the improved earnings per share created by the convertible preferred; and it is, therefore, in the common stockholder's interest. There are no empirical studies that prove the
argument one way or the other.

The previous sections of this paper have concentrated on the use of convertible preferred stock from the point of view of the issuer. The remainder of this paper will view the convertible preferred from the point of view of the investor and the public at large.

**Investor Interest In Convertible Preferred**

Investors are interested in convertible preferred stocks because of the opportunity for profit that they provide. There are two ways in which an investor profits by owning a convertible preferred. One way is the dividend he receives and the other is in his option to convert the security into common stock. Let us look at the market price of a convertible preferred and how it is determined.

One of the factors an investor takes into consideration when evaluating a convertible preferred is the conversion value of the security. This can be computed simply by multiplying the number of common shares the convertible preferred is convertible into by the market price of the common. For instance, assume a convertible preferred converts into 1 1/2 shares of common stock which is currently selling for $40 per share. Multiplying the number of shares of common stock the convertible preferred is convertible into times the market value of the common stock will result in a conversion value of the preferred equal to $60.

The second factor an investor considers when evaluating a convertible preferred is its investment value. This
is a somewhat more nebulous value than the conversion value but can be computed with some accuracy by a competent investment analyst. The theory of the computation is to determine what the convertible preferred would sell for if it were offered as a straight preferred and depended on its dividend alone for its value. The steps to follow in such a determination require judgment and knowledge of the market. First, the analyst would judge the quality of the preferred based on the issuer's earning power and risks. Second, he would relate the issue he is trying to value to issues of straight preferreds with similar investment qualities. The analyst estimates the investment value based on the quality of the stock and the yield at which other similar issues are selling in the market.

The two values discussed are both considered when determining at what price the convertible preferred will sell in the open market. Which of the two values does the convertible preferred sell at? If the security has been properly designed and priced by the issuer, it will sell at neither of the two values. It will sell at a premium over the highest of the two values. Why is this so?

There are at least three major factors that produce the premium on a convertible preferred stock. Two of them are related to the favorable market position the investor has when he purchases convertible preferreds. On the up side of the market the holder of a convertible preferred can participate in the potential increase in the price of common stock.
through his conversion right. Assuming that the conversion price of the issue is close to the market price of the common, there is a good probability that the conversion right will have real value in the future. On the down side of the market the holder of a convertible preferred is protected by the investment value of the security. The investment value of the security could change if the money market conditions or the quality of the preferred changed. These conditions generally are not as volatile as the price of common stock, however. The investor, therefore, finds himself protected regardless of which way the market moves. The greatest degree of protection is afforded to the investor when the conversion value and the investment value are close to each other.

The logic of this statement can be proven by some examples. Assume that an issue has a conversion value of $50 and an investment value of $50. If the price of the common falls, the conversion value will fall, but the investment value is unchanged. If money market conditions change, the investment value of the preferred will change, but the conversion value will not. It is apparent then that the investor has a high degree of protection when the conversion and investment values are equal.

Now assume an issue that has a conversion value of $75 and an investment value of $50 and the security is selling at its conversion value of $75. If the price of common stock were to drop by 50%, the conversion value of the
preferred would fall to $37.50. The security should now be selling at least at its investment value of $50. The investor has taken a "paper loss" of $25, however. The larger the spread between conversion value and investment value, the less protection the investor has.

The investor is willing to pay for protection. Therefore, the greater the degree of protection, the greater the premium above the higher of conversion or investment value the investor is willing to pay. This relationship was illustrated in an article authored by Anthony H. Meyer, Vice President in charge of the Counseling Department for Irving Trust Company.¹

Mr. Meyer selected a random sample of fifty convertible preferred stocks from an issue of "Moody's Convertible Preferreds." Moody's issues a listing of data on publicly held convertible preferreds monthly. The data includes the conversion value, estimated investment value and the per cent premium on the issue. Mr. Meyer computed the per cent premium of each of the issues over the higher of conversion or investment value and plotted it on the vertical axis of a graph. The horizontal axis was conversion value as a per cent of investment value. The result showed a very significant concentration of high premiums around the point where conversion value was close to 100% of investment value.

There are other factors which have an effect on the

¹Meyer, 52.
size of the premium paid for a convertible preferred. The call feature is one of them. If the security has a low call price that will force conversion, the security will not sell much above its conversion value. If the security has call protection and high redemption prices, the premium will tend to be higher. Yield differential between the preferred and the common can also affect the premium. If the common has a dividend yield significantly below that of the preferred, investors may place less value on the conversion option and this may tend to reduce the premium. Special conversion privileges such as delayed conversion, reduction in the conversion ratio after a period of years, or other similar provisions will tend to reduce the premium.

Another major factor contributing to the premium on convertible preferred is the special market demand for these securities. Certain investors have special reasons for purchasing convertible preferreds. Because of their appreciation potential and the increased dividends over the underlying common stock, trustees by investing in them can reconcile the interests of income beneficiaries and remaindermen of trusts. Insurance companies invest in them because of regulatory and tax considerations. These special markets can increase the demand for a particular issue of convertible preferred and, therefore, increase the premium on the security.

The foregoing discussions of the conversion value and investment value of convertible preferreds makes it clear that the investor is in a hedging position when he invests in
convertible preferreds. By taking a hedging position the investor does sacrifice some of the gain he would have received if he had invested in either preferred stock or common stock outright. If the investor had invested in a straight preferred stock of the same company, he would have received a higher dividend rate than the rate he receives on the convertible preferred. This statement follows from the earlier discussion of why companies issue convertible preferreds. One of the reasons was that the dividend cost would be less because the investor would look to the conversion privilege as part of his value received for investing in the security.

If the investor had invested in common stock of the company rather than the convertible preferred, he would have the opportunity of making a greater gain in the rising market. This is true because of the premium above the higher of investment or conversion value that the investor pays for the hedging protection of the convertible preferred. The premium reduces as the price of the common increases; therefore, the conversion value of the convertible preferred increases and approaches the conversion price of the convertible preferred. When the conversion price and the conversion value of the convertible preferred are equal, the premium will be zero and the security will sell at its conversion price.

One may well ask at this point: where has the investor lost? The premium he paid for the convertible
preferred has eroded in value to nothing, but then the conversion value of the security has increased to the point where it is now profitable to convert.

The explanation lies in the magnitude of the two changes. The increase in value due to the increase in the conversion value of the security does not offset the loss from the erosion of the premium. Reference to the earlier discussion of the factors that make up the premium on convertible preferreds might be helpful here. As the conversion value of the security approached the conversion price, it digressed further from the investment value and the investor lost his hedge position and became more of a common stockholder, subject to the risks of a common stockholder. Therefore, the premium was reduced because of the decreased protection provided by the investment value and because of the loss of its preferred position upon conversion into common.

Much has been said to this point about conversion provisions, conversion value, and conversion price; but what induces the individual holder of a convertible preferred to convert his holdings into common stock? Anthony H. Meyer has listed four reasons for converting convertible preferred stock: "an opportunity for arbitrage, a dividend differential in favor of the common, a change in conversion rights, or a call."\(^1\)

Arbitrage is the practice of buying and selling the

\(^1\)Ibid. p. 56.
same article in different markets at the same time to take advantage of price differentials. This practice applies to convertible securities when the conversion value has risen to the point where the premium has disappeared. Daily fluctuations in the price of the convertible preferred and the common stock will cause the common stock to sell at a discount from the conversion value of the preferred. When this situation arises, arbitragers will purchase the convertible preferred and sell the common stock short at the same time. They will then convert the preferred to cover the short sale and collect their profit. The average holder of convertible preferred stock is not involved in this type of transaction, but it can become a significant reason for conversion when the preferred is selling at its conversion value.

The second reason for converting preferred stocks is a dividend differential between the common and preferred stock. A holder might be induced to convert if the dividend he would receive from the common stock would be higher than the dividend he receives on the preferred stock. There is no single point at which all holders would convert, however, because each holder must take the relative risks of the two securities into account when making his decision. If he is willing to forego the higher dividend of the common stock in exchange for the greater security of the preferred he will not convert.

Another reason for conversion was discussed earlier
under conversion rights. This is a change in or loss of conversion rights. Most convertible preferreds have a single conversion rate that is perpetual. Some convertible preferreds lose their conversion privilege at a specified time, and many others have conversion rights that become less advantageous as time passes. There is a strong inducement for the holder to convert if his security is selling at its conversion value and the conversion price is going to increase by 10% at a specified date. His decision to convert will depend on the value he places on the greater security of the preferred, the relation between investment and conversion values, and the size of the conversion price adjustment.

The final reason for conversion is if the company calls the security. Virtually all of the issues of convertible securities allow the issuer to call the security for a specific cash price. If the call price of the security is below the conversion value of the security, the holder would lose money by not converting the security. The company has forced him to convert, in other words.

In the past few decades the institutional investor has become an increasingly potent force in the securities market. No discussion of investors' interest in convertible securities would be complete without some reference to the institutional investors' acceptance of them. Much of the material utilized in this section comes from the previously referenced study by C. James Pilcher.

The factors that make convertible preferred stocks
interesting to individual investors also apply to institutional investors. Due to regulation and the specific objectives of some groupings of institutional investors, they may or may not look with favor on convertible preferreds. Life insurance companies have more investment funds than any other single group of institutional investors. Life insurance companies are regulated as to the amount and quality of equity stock that they can invest in. That they are interested in convertible preferreds is evidenced by a statement by the financial vice president of one of the ten largest companies.

"Convertible debentures and preferred stocks are of definite investment interest to life insurance companies. I believe a study of the investment record of a number of companies will show that over the past ten years acquisitions of convertible issues have been increasing."1

Another group of institutional investors of prime importance in gauging the acceptance of convertible securities are the mutual funds. A brief survey of the ten largest open-end mutual funds and the ten largest closed-end mutual funds as listed by the 1967 edition of Moody's Bank and Finance Manual shows that 70% of them hold convertible preferred stocks. The holdings are small in comparison to total investments, generally less than one per cent, but are still substantial when viewed in actual dollars.

Other institutional investors such as fire insurance companies and banks are restricted by regulation from investing in convertible preferred stocks or indeed any equity

1Pilcher, 111-2.
securities. The regulations referred to are state regulations and the individual states very greatly in what is defined as a permissible investment.

It appears that the institutional investors, where permitted by regulation, have an interest in convertible preferred stocks generally for the same reasons that the individual investor is interested.

**Is Use Of Convertible Preferreds In The Public Interest?**

To this point we have discussed convertible preferred stock from the viewpoint of the issuing company and from the viewpoint of the purchaser or receiver. The emphasis has been on the positive side of convertible preferreds. Now let us expand our discussion and look at convertible preferred stock as a potential problem from both the issuers' and receivers' views as well as the general public's view.

One of the arguments against convertible preferred stocks that one frequently hears and has been touched on earlier in this paper is the comment that the convertible preferred dilutes the equity of the common shareholder. This is especially true in the case of acquisitions or offerings without preemptive rights so that the common stockholder does not have the opportunity guaranteed to him to protect his equity interest. Is this argument a valid one?

Generally, it appears that it is not. The common holder need not lose value in the company because of the issuance of convertible preferred stock. It is true that he will own a lesser portion of the company after conversion,
but that lesser portion should be worth more to him than if the convertible security had not been issued. Assume that a convertible preferred, convertible into one share of common, is sold or utilized in an acquisition and has a conversion price of $50 per share when the price of the common is $35 per share. Because of the conversion factor, the convertible preferred can be sold at a dividend cost of 1% below that of a straight preferred.

Let us now assume that the company is successful in its operations and the price of the common stock goes to $50 per share in ten years and the preferred owner converts. Have the common stockholders suffered a loss? No, they have had the advantage of lower dividend costs on the convertible preferred and the funds that were retained in the firm because of the lower dividends could be reinvested in the operations of the firm. If common stock had been sold instead, it would have been sold at $35 per share and more shares would have been issued to obtain the same aggregate proceeds as the convertible issue, thus causing a greater and an immediate dilution of equity.

Now let us assume that the company has not been as successful in its operations and at the end of ten years the common stock is selling for $40 per share. At this point the convertible preferred owner will not convert. The common stockholder still has the benefit of the lower dividend cost and the use of the aggregate proceeds without the disadvantage of the effect of the additional shares of common created.
by conversion on the reported earnings per share of the common. In effect, the common stockholders have received value for a right to convert that has been up to this point worthless; they have traded nothing for something. In either case, the common shareholder has not suffered a loss of value of his portion of the company because of the issuance of convertible preferred stock.

The above discussion does touch on a potential problem that affects the public as a whole. The problem is discussed in an article by Francis H. Schott of The Equitable Life Assurance Society.1 Mr. Schott points out that one of the main reasons for investing in a convertible security is to obtain a hedge against inflation by allowing conversion at the holder's option into common stock. In effect, the investor is betting that inflation will continue and in all probability will increase. Mr. Schott feels that if enough convertible securities are outstanding, the country may find itself in the position of supporting the financial soundness of the country by supporting inflation. Inflation would be required to meet the profit projections and stock prices necessary to justify the basis on which the convertible securities were sold. If some future government administration sought to end the inflationary spiral, the effect on the market for convertible securities could be disasterous and could

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carry over to the economy as a whole.

Mr. Schott has an interesting argument and one cannot deny that inflation finds its way into corporate projections of earnings and stock prices. Inflation has its effect on all securities and not just convertible securities, however. It appears that convertibles could become less attractive to issuers and investors in a declining economy.

Another objection to convertible preferred stock centers around its use in acquisitions to create a pooling-of-interests. The objection is more specifically to pooling-of-interests and the effect it has on reported earnings per share. As was noted earlier, pooling-of-interests increases reported earnings per share because of the lower valuation of the assets of the acquired company resulting in lower depreciation charges and the absence of goodwill that would have to be written off in future income periods.

Mr. J. S. Seidman of the Accounting Principles Board of the American Institute of Certified Public Accountants authored an article in which he disagreed with the concept of pooling-of-interests. In his view, it is poor and misleading accounting practice to account for the assets purchased in an acquisition at the seller's cost rather than the price paid for them and to hide the goodwill paid for the acquired firm. It is difficult to argue with his logic. It is easy to see why corporations utilize the concept, but is it in the public interest to show higher earnings because of an accounting treatment than would be the case under other
reporting practices. Mr. Seidman thinks not and states as follows:

"Accounting must be neutral. Its sole function is to "present fairly" the financial and operating picture. To be a fair presentation it must do right not only by the present but also by the potential stockholders, creditors and others concerned.

"In my opinion, the concept of pooling of interests, and the resulting suppression of costs, makes accounting run afoot of these cardinal principles. In an acquisition, the acquirer should account for the assets acquired at their cost to the acquirer. That cost is the price actually involved in the transaction. If it is a cash price, the cost is the amount of cash. If it is a stock price, the cost is the value behind the stock." 1

In view of the controversies surrounding pooling-of-interests, dilution of equity and the perpetuation of inflation is or is not convertible preferred stock in the public interest. In my judgment, the answer is yes. It allows the corporation to obtain funds at lower costs and to obtain funds it might not be able to under other methods. Convertible preferred stock provides the management of a company with a great degree of financial flexibility. Management can draft its terms and provisions to effect an acquisition or it can be used to obtain future common equity at attractive prices. The common stockholder of the issuing corporation gains the earning power of the funds provided by the convertible preferred and suffers less dilution than would be the case if common stock were sold.

The investor gains the advantage of a hedge position in the market and is protected whether the market rises or falls. Admittedly, there are more factors for the investor to consider when investing in convertible preferred stocks than when investing in preferred or common stock. The Securities and Exchange Commission makes the investor's task easier in that it demands that adequate and truthful information be provided about the security and the company to allow the investor to make a decision. Let the purchaser of convertible preferred stock make use of the information available to him and take his chances in the market with investors in other securities.
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<td><strong>Transportation:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number - yes</td>
<td>5</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>- no</td>
<td>1</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>Per cent - yes</td>
<td>83%</td>
<td>67%</td>
<td>100%</td>
</tr>
<tr>
<td>- no</td>
<td>17</td>
<td>33</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total Industries:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number - yes</td>
<td>35</td>
<td>37</td>
<td>38</td>
</tr>
<tr>
<td>- no</td>
<td>15</td>
<td>13</td>
<td>12</td>
</tr>
<tr>
<td>Per cent - yes</td>
<td>70%</td>
<td>74%</td>
<td>76%</td>
</tr>
<tr>
<td>- no</td>
<td>30</td>
<td>26</td>
<td>24</td>
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</table>
TABLE II

Motivation for Issuance of Convertible Preferred Stocks by Industry 1962-67, Fifty Corporations

<table>
<thead>
<tr>
<th>Industry</th>
<th>To Raise Capital Funds</th>
<th>For Mergers and Acquisitions</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial:</td>
<td>5</td>
<td>25</td>
<td>30</td>
</tr>
<tr>
<td>Number</td>
<td>17%</td>
<td>83%</td>
<td>100%</td>
</tr>
<tr>
<td>Per cent</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public Utility:</td>
<td>7</td>
<td>7</td>
<td>14</td>
</tr>
<tr>
<td>Number</td>
<td>50%</td>
<td>50%</td>
<td>100%</td>
</tr>
<tr>
<td>Per cent</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transportation</td>
<td>0</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Number</td>
<td>0%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Per cent</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Industries:</td>
<td>12</td>
<td>38</td>
<td>50</td>
</tr>
<tr>
<td>Number</td>
<td>24%</td>
<td>76%</td>
<td>100%</td>
</tr>
<tr>
<td>Per cent</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
TABLE III

Voting Rights of Convertible Preferred Stocks by Industry 1962-67, Fifty Corporations

<table>
<thead>
<tr>
<th>Voting Rights Equal With Common Stock</th>
<th>Voting as a Class</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Create Equal or Prior Stock</td>
<td>if Default</td>
<td></td>
</tr>
<tr>
<td>Raise Capital Funds:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number - yes</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>- no</td>
<td>8</td>
<td>2</td>
</tr>
<tr>
<td>Per cent - yes</td>
<td>33%</td>
<td>83%</td>
</tr>
<tr>
<td>- no</td>
<td>67</td>
<td>17</td>
</tr>
</tbody>
</table>

Mergers & Acquisitions: |  |
| Number - yes | 31 | 27 | 29 |
| - no | 7 | 11 | 9 |
| Per cent - yes | 82% | 71% | 76% |
| - no | 18 | 29 | 24 |
BIBLIOGRAPHY

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Seidman, "Pooling Must Go," Barron's, (July 1, 1968), 10-14+

PROSPECTUSES


REPORTS

