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Ward S. Curran

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Preferred Stock In Public Utility Finance — A Reconsideration

by Ward S. Curran

The recent literature on preferred stock is replete with statistics attesting to the growing unpopularity of this instrument in financing American corporations.\(^1\) The disenchantment has even carried over to the traditional stronghold of preferred stock—public utilities.\(^2\) From the data shown in Table 1 it is apparent that over the last two decades preferred stock offered for cash has until very recently declined in importance among the new issues of all corporations as well as the new issues of utilities. (The rate of decline was greater for non-utility corporations, however, so that the percentage of preferred stock accounted for by utilities has, at least through 1970, actually increased.)

Although the data clearly indicate disenchantment with preferred stock, there are market factors that suggest that management of public utilities may begin to place a somewhat greater reliance upon this mode of finance. In the remainder of this article we shall develop a rationale for a reevaluation and apply the argument to trends in public utility finance.

Differences in Tax Treatment

Management can and often does view preferred stock, at least nonconvertible preferred, as an alternative to debt financing. However, because interest is tax deductible and preferred dividends are not, preferred stock is looked upon as a poor substitute for bonds or debentures. Assume for the moment that management makes no allowance for differences in risk when employing debt or preferred stock. Then in order for management to be indifferent as to debt or preferred stock financing, the latter must sell at a lower yield. Using a marginal tax rate of 48 per cent we have:

cost of preferred = cost of debt - .48 cost of debt cost of preferred = cost of debt (1-.48) cost of preferred = .52 cost of debt.

1. Footnotes appear at end of article.

The author is Professor of Economics, George M. Ferris Lecturer in Corporation Finance, and Director of Institutional Planning at Trinity College, Hartford, Connecticut. He has written and done consulting work in corporation finance and related areas. Among his latest publications is Principles of Financial Management, McGraw-Hill, 1970.

Under our simplifying assumptions, management would just as soon employ preferred stock as debt financing if the yield on the former were

0.52 of the yield on the latter. While the income tax laws discourage the issuance of preferred stock, they encourage corporations to buy it for income purposes. Those doing so may, with exceptions noted later, exclude 85 per cent of the dividends from their taxable income. Again if we assume that investors ignore risk differences in holding debt or nonconvertible preferred stock, then the latter can sell at a lower yield and still be an acceptable investment. More specifically, to the corporate investor:

yield on preferred — tax rate x .15 (yield on preferred) = yield on debt tax rate (yield on debt).

If we let x equal yield on preferred, w equal the yield on debt, and t equal the tax rate then we have:

$$\begin{aligned} x - .15 & tx = w - tw \\ x & (1 - .15t) = w & (1 - t) \\ x & = \frac{w & (1 - t)}{(1 - .15t)} \end{aligned}$$

If the marginal tax rate paid by the corporate investor was .48, then we have:

$$x = \frac{w(1 - .48)}{1 - .072}$$
$$x = \frac{.52w}{.928}$$
$$x = .56w$$

yield on preferred = .56 yield on debt.

Under the assumptions specified, therefore, the yield on preferred for the corporate investor could be as low as 0.56 of the yield on debt and still be as attractive as an investment. To the issuer, however, under the same set of assumptions the cost of preferred would have to be 0.52 of the cost of debt before substituting it for bonds.

Not all corporate purchasers, of course, pay 48 per cent of their income in taxes. Financial intermediaries in general have lower effective rates. Life insurance companies in particular are taxed at lower rates. Moreover there are often restrictions on the amount of stock in the portfolios of

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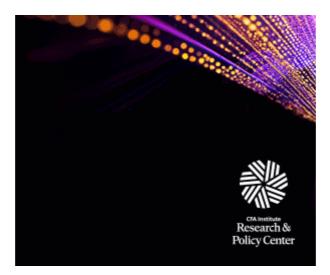
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