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# A PREFERENCE FOR PREFERRED SHARES

by Augusto L. de Leon\*

*Preferred stocks have not been a popular source of external financing in the Philippine capital markets. Yet it offers advantages like assured control for common stockholders, flexibility in dividend service, perpetual term and strengthened equity based on the issuing company. The main reason for the lack of availment of this financing source by companies is its high cost to the issuer. This paper proposes that this impediment be eliminated by making preferred stock dividends tax deductible. This move would encourage the issuance of preferred stocks, help stimulate the Philippine capital market and channel financing to support corporate investments.*

Equity financing has been a major concern for many companies. To a large extent, the financing requirements of a company determine its future in terms of sales, ownership, and net income. A company can thrive and be competitive only insofar as it has the financing to support its growth and expansion.

There are two major sources of equity financing: borrowings and equity infusion. Borrowings are debts obtained from private and public sources while equities are capital investments obtained through the issuance of preferred and common stocks. A company has the obligation to pay interest and principal amortizations for debts. On the other hand, dividends are paid to preferred and common shareholders.

Both borrowings and common shares have limitations insofar as flexibility and control are concerned.

A company has an obligation to pay interest on a loan and amortize its principal regardless of whether it earns income or not. Interest expense takes prior claim on earnings and unless a moratorium on debt is negotiated, interest as well as maturing portions of the principal will have to be regularly paid. Creditors are given priority such that in the event of a liquidation, creditors have to be paid first before the stockholders. As such, borrowings make a corporation inflexible by obligating it to make interest and principal payments in addition to planning for refinancing. Management control by internal common stockholders is often sacrificed to favor outside creditors.

Recently, the debt-to-equity swap has made available funds for equity investment, but still control becomes a problem since the creditors now become the owners of

the company and therefore can dictate policies and procedures which can be different from that preferred by the original owners and incorporators of the company. This type of equity financing becomes even more pronounced because of the pressure coming from financing institutions who want to take advantage of discounts on swap and avail of the earlier liquidation of foreign debt.

Meanwhile, the issuance of common shares of stocks beyond the financial capability of a business enterprise becomes a source of concern since corporate control can be threatened. An influential or moneyed group of persons can buy a majority of the common shares of a company and dictate its internal policies. The group can also change the composition of management and board of directors depending on the number of shares that it controls. These so-called "corporate raiders" represent the single biggest threat to companies that issue common shares. As such, control is sacrificed in exchange for equity. Indeed, the Philippines has a history of corporations engaged in prolonged and costly legal battles for management control. The controversy over the ownership of these companies serves as a deterrent to companies considering a decision to issue common shares. *San Miguel Corporation's* capital stock, for example, does not have the distinction between common and preferred shares but its Class A and B shares have voting powers which are very much like common shares in essence and function.

In the case of a company issuing less than 50 percent of its common shares of stock to the public, there would be a tendency for the minority share to be controlled by a few business associates, and even in an equity structure such as this, squabbles do take place when the minority group becomes interested in participating in management.

As such, it can be seen that both borrowings and the issuance of common shares of stocks are risky approaches

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to financing. This high risk can be seen in terms of either loss of flexibility or of current management control.

There is, however, an instrument not popularly utilized in the Philippine corporate scene which minimizes the risk of losing current control but provides the added feature of flexibility. *Preferred Shares* are popularly known as a "hybrid" of loan and common shares financing. They provide financing similar to loans. The types and terms of preferred shares vary from those which provide payment of dividends at a fixed rate to those which provide participatory and convertibility features. While stockholders can opt not to declare dividends on preferred shares if earnings are low, earnings can be made cumulative and will always take precedence over dividends of common shares. In preferred shares, the problem of management control from external influence is reduced because the holders of preferred shares have no voting rights. Companies can therefore pursue their plans and priorities without much disruption ensuing from changes in stockholders. However, this loss in voting power is compensated by preferred shares' priority to dividends. This priority is also enhanced by the cumulative feature of preferred shares. This means that before a company declares dividends to common shareholders, it must first pay the dividends in arrears to its preferred shareholders.

Another characteristic of preferred shares is perpetuity. They carry no final maturity which consequently gives ample room for flexibility for many companies. Moreover, an increase in preferred shares also bolsters the equity base of a company thereby increasing its ability to absorb more loans in the future. Preferred shares can provide an outlet for the funds generated by the debt-to-equity swap and become an investment outlet for a broader base of capital holders looking for a fixed return in their investment.

Based on the aforementioned advantages of preferred shares and taking into account the limitations of borrowings and common shares, it seems that the issuance of preferred shares is a more viable medium by which to generate additional equity.

Why then is it not utilized by many corporations especially those with a track record in terms of earnings and stability? A proposal is raised in this paper to remove the single most important disadvantage of preferred shares and to explain the basic reason for its non-use in the Philippine capital market.

Preferred shares cost more than long-term loans because dividends are not deductible as expense unlike interest on loans.

One can argue that this is also true with common shares but the latter is justifiable since in essence common shareholders are the "ultimate owners" controlling the management of the corporation and that their income should rightfully not be deducted as expense. While preferred shares, on the other hand, can be an attractive investment outlet for public investment, corporations do not issue these shares due to this severe financing cost disadvantage.

The high cost of preferred shares in terms of its non-deductibility, expense and non-voting features is the major reason why in the Philippine stock markets, preferred shares are not offered and traded as much as common shares. In the Makati Stock Exchange, records show that out of the 139 companies listed in 1987, only five companies offered preferred shares. Among the five companies, only two were actively traded, i.e., *Benguet Corporation* and *Philippine Long Distance Telephone Company (PLDT)*. Preferred shares trading was so thin that they only constituted 0.3 percent of the P1.03 billion worth of shares traded at the Makati Stock Exchange in 1987. The preferred shares of *Benguet Corporation* were traded because they can be converted to common shares. Meanwhile, *PLDT's* preferred shares' traded value reached P3.07 million in 1987. It is only logical for *PLDT* to issue preferred shares in the stock market since public utilities (and monopolies in general) are able to pass the high cost of preferred shares to the public. In the case of *PLDT*, the preferred shares' owners constitute the telephone owners in the country.

A glimpse of the profile of companies whose stocks are heavily traded at the Makati Stock Exchange will reveal the minimal amount of preferred shares issued by these companies. A great majority of companies in the Philippines whose stocks are either traded or non-traded in the stock markets have minimal issues of preferred shares. Stocks of *San Miguel Corporation*, *Ayala Corporation*, *Atlas Fertilizer*, *Atlas Consolidated Mining*, *Philex*, *A. Soriano*, and *Lepanto* all have stocks classified as "A" or "B", whose distinction is such that "A" can only be owned by Filipinos and "B" by persons of any other nationality. However, in essence these stocks can be classified as common stocks because of their voting rights.

Meanwhile, in 1986, *Bank of the Philippine Islands (BPI)* only had 1.2 percent of its outstanding stocks as preferred, *First Philippine Holdings* had only 13.9 percent and *Benguet* 1.2 percent. In the companies studied, only *PLDT* had a majority (78 percent) of its outstanding stocks as preferred for reasons already cited.

In the light of observations noted with regard to features of preferred shares in the local corporate scene,

attention is called to its 'non-deductibility as an expense' feature which should be studied seriously. Motivation for issuance and trading of preferred shares can be adequately provided by allowing dividends to be considered as an expense and by providing it with advantageous features such as flexibility, control, larger capital base and as an outlet for debt-to-equity swaps.