

Tax Options, Clienteles and Adverse Selection: The Case of Convertible Exchangeable Preferred Stock

Executive Summary

Investors in convertible preferred stock have the option to convert the preferred into common stock. Convertible exchangeable preferred stock works the same way, but adds the right for the issuing firm to exchange the preferred shares for convertible bonds in the future. An exchange must preserve the conversion terms, and the coupon rate on the new bond must match the preferred dividend rate that it replaces.

A firm that raises capital using convertible preferred stock may find itself able to benefit from the tax deductibility of convertible debt interest in the future. Convertible exchangeable preferred lets the firm obtain additional tax deductions when it can use them, free of additional underwriting costs. This tax-timing option is valuable to an issuing firm that is in a low tax bracket when it raises capital but may face higher tax rates in the future. However, an exchange can be detrimental to investors. Corporate investors exclude the majority of a cash dividend (currently 70%) from taxation. An exchange would force such an investor to either endure a reduction in after-tax income, or incur the expense of selling the securities and reinvesting its funds. Thus, a potential reason for avoiding exchangeable convertible preferred is if the firm has or can attract an investor clientele that seeks stable preferred dividends. The firm can gain from serving the clientele if the investors are willing to accept a reduced yield (on non-exchangeable convertible preferred stock) in return for stability, or if being able to come back to the clientele for future offerings reduces the firm's financing costs.

Management should consider the firm's tax status and the target investor clientele when deciding between the conventional and exchangeable forms of convertible preferred stock. If taxable institutions are likely buyers of the issue, and the firm foresees little need for interest

tax shields in the future, traditional convertible preferred stock potentially can minimize the cost of capital and smooth the way for future offerings. If there is a high likelihood that the firm can benefit from the tax shields obtainable by swapping the preferred for debt, for a sustained period before conversion can be forced, a convertible exchangeable preferred issue can make sense. This is especially true if the issue can be marketed to investors that are indifferent between dividends and interest, such as mutual funds and individuals.

The issuing firm gives up a valuable tax-timing option if it issues non-exchangeable preferred. The cost of foregoing the tax option can outweigh the benefits of serving a dividend-seeking clientele. The firms for which it is most costly to give up the tax option — those in higher tax brackets, those that have little debt in their current capital structures or are repaying debt with the proceeds of the offering — are predicted to be the most likely to issue exchangeable preferred. My empirical findings support this contention: higher marginal tax rates, lower debt ratios, and the repayment of long-term or bank debt from issue proceeds do indeed increase the likelihood that a firm chooses exchangeable over non-exchangeable convertible preferred.

The stock market tends to react unfavorably to the announcement of any convertible security offering. Desiring to limit the damage to its common stock price, management may try to signal the firm's favorable prospects through its choice of security terms. If the common stock price rises rapidly so that the preferred is converted soon, the exchange option may never be exercised. A manager who foresees this situation can try to imply that the firm will perform well by not including the exchange feature. A manager who isn't so optimistic will conclude that the tax-option value of the exchange feature is worth more than any potential signal. Thus, only issuers with comparatively poor prospects would choose convertible exchangeable preferred stock. This scenario is called the *adverse selection* explanation for the choice of security type.

Adverse selection implies that conventional convertible preferred issues would be called, to force conversion, earlier in their lives than exchangeable convertible preferred issues. Em-

pirically, I find that the opposite is true, though the difference is small. Adverse selection also implies that the common stock-price reaction to an exchangeable offering should be more negative than the reaction to a non-exchangeable offering. On first examination, this prediction has empirical support: the average stock-price reaction evoked by exchangeable offering announcements is in fact the more negative of the two. However, after controlling for the use of proceeds, leverage and growth opportunities, little evidence remains that the security type chosen influences announcement effects. The stock market seems to attune its reaction to an offering in keeping with the purpose of the offering, the firm's capital structure and growth policies, and the quality of its management, not whether the preferred is exchangeable for debt. Thus, managers should not consider the potential to influence stock-market reaction to be a decisive factor in the choice between the two convertible preferred security types.

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