

Preferred Shares Versus Common Shares: A Comparative Analysis for Investors and Companies

Introduction

The landscape of corporate finance offers a variety of instruments for raising capital and for investors to participate in the growth and profitability of businesses. Among these, preferred and common shares stand out as fundamental forms of equity ownership. While both represent a stake in a company, they differ significantly in the rights, benefits, and risks they confer to both investors and the issuing corporations.¹ Understanding these distinctions is crucial for investors seeking to align their investment strategies with their financial goals and risk tolerance, as well as for companies aiming to optimize their capital structure and meet their financing needs effectively. This white paper provides a comprehensive analysis of preferred and common shares, exploring their definitions, key characteristics, advantages and disadvantages from an investor's standpoint, the motivations behind their issuance by companies, and their respective risk and return profiles.

Defining Preferred Shares and Their Key Characteristics

Preferred shares represent a distinct class of stock that offers holders a higher claim on a company's dividends and assets during liquidation compared to common stockholders.⁵ Often described as a hybrid security, preferred stock combines attributes of both common stock and bonds.¹ Similar to bonds, preferred shares typically provide a fixed dividend payment, offering a predictable income stream. However, akin to common stock, they represent an ownership interest in the company.¹ This blend of features makes preferred shares an appealing option for investors seeking a combination of income and equity exposure.

One of the primary characteristics of preferred shares is their dividend priority. Holders of preferred stock are entitled to receive dividend payments before any dividends are distributed to common shareholders.¹ This preferential treatment reduces the income risk for preferred shareholders compared to those holding common stock. Furthermore, in the event of a company's liquidation, preferred stockholders have a higher claim on the company's assets than common stockholders, although their claim is subordinate to that of bondholders.¹ This provides a degree of downside protection for preferred shareholders compared to common shareholders in the event of financial distress. In contrast to common stockholders, preferred shareholders generally do not possess voting rights in corporate matters.² This lack of control over company decisions might be a drawback for some investors who prefer to have a say in the governance of the companies they invest in.

Preferred shares come in various forms, each with specific features designed to cater to different needs and preferences. **Cumulative preferred stock** includes a provision that if a company misses dividend payments, these unpaid dividends accumulate and must be paid to preferred shareholders before any dividends can be distributed to common stockholders.¹ This feature provides income security for investors who prioritize predictable returns. Conversely, **non-cumulative preferred stock** does not accumulate unpaid dividends, meaning that if a dividend payment is skipped, preferred shareholders have no right to claim those missed payments in the future.¹ These shares typically carry a higher yield to compensate investors for the increased risk of potentially missing dividend payments.⁷ **Convertible preferred stock** offers holders the option to convert their preferred shares into a predetermined number of common shares.¹ This type of preferred stock provides the potential for capital appreciation if the company's common stock price increases significantly. **Callable preferred stock** gives the issuing company the right to redeem the preferred shares at a specified price after a certain date.¹ This feature introduces reinvestment risk for investors if their shares are called when interest rates are lower, potentially forcing them to reinvest at less favorable terms. Finally, **participating in preferred stock** may allow shareholders to receive additional dividends beyond the stated fixed rate if the company achieves certain financial goals or if common stock dividends exceed a specific level.² This offers an opportunity for higher returns if the company performs exceptionally well. The availability of these various types of preferred shares allows companies to structure their offerings to appeal to a wide range of investors and to meet their specific financing objectives.

Defining Common Shares and Their Fundamental Features

Common shares represent the basic unit of ownership in a corporation.² When an investor purchases common stock, they are essentially buying a fractional ownership in the company, entitling them to a claim on a portion of the company's assets and earnings.² Common shares are the most prevalent type of stock traded on the stock market and form the foundation of equity ownership for most publicly traded companies.²

As proof of the capital they have contributed to the company, business owners and other investors receive common shares.¹⁰ Common shares constitute a part of the company's overall shareholder equity¹⁰, representing the fundamental equity interest in the corporation. A key feature of common shares is the voting rights they typically grant to shareholders. Each share of common stock usually entitles the holder to one vote in corporate matters, such as the election of the company's board of directors and decisions on significant corporate policies.² This right allows shareholders to have a say in the company's governance and strategic direction. However, some companies issue different classes of common stock, which may have varying voting rights.²³ This practice

often allows founders or key individuals to maintain control over the company while still raising capital by issuing shares with limited or no voting rights to other investors.

In terms of the company's capital structure, common shareholders have the least claim on its assets in the event of liquidation. They are paid only after all creditors and preferred shareholders have been fully compensated.² This position represents a higher risk for common shareholders in case of company failure. Additionally, common shareholders receive dividend payments only after preferred shareholders have been paid their due dividends.² Consequently, dividend payments to common shareholders are less certain and can fluctuate depending on the company's profitability and the board of directors' decisions.

Investor Perspective: Advantages and Disadvantages

Investing in preferred shares offers several potential benefits for investors. One key advantage is the dividend priority, as preferred stockholders receive fixed dividends before common stockholders, providing a more stable and predictable income stream.¹ This makes preferred shares particularly attractive to income-seeking and risk-averse investors. Furthermore, preferred shares generally offer the potential for higher yields compared to common stock and sometimes even the company's bonds.¹ This can provide a higher return on investment compared to other lower-risk investment options. The price of preferred stock tends to be less volatile than that of common stock, offering a more stable investment compared to the fluctuations often seen in the common stock market.¹ In the event of liquidation, preferred shareholders have a higher claim on the company's assets than common stockholders¹, providing a degree of safety net, although they are still subordinate to bondholders. Some preferred stocks also feature a cumulative dividend provision, which ensures that if a company misses any dividend payments, these must be paid in full to preferred shareholders before any dividends can be distributed to common shareholders.¹ This further reduces the risk of lost income due to temporary financial difficulties faced by the company.

Despite these advantages, investing in preferred shares also has certain drawbacks for investors. A significant limitation is the typically limited or complete lack of voting rights in corporate matters.² This means that preferred shareholders generally do not have the opportunity to participate in electing the board of directors or influencing other major company decisions, which might be a concern for investors who wish to have a say in the management of the companies they invest in. Preferred stock also generally has less potential for significant capital appreciation compared to common stock², making it less attractive for investors primarily seeking high growth. In the event of a company's liquidation, while preferred shareholders are paid before common shareholders, they are still subordinate to the company's debt holders, such as bondholders², indicating that preferred shares carry more risk than debt instruments. The callable feature of

some preferred shares also presents a risk, as the company can repurchase these shares, potentially forcing investors to reinvest their capital at less favorable interest rates.¹ This introduces uncertainty into the investment's duration and potential returns. Finally, while preferred dividends have priority over common stock dividends, they are not guaranteed and can be suspended if the company experiences financial difficulties, although non-payment can negatively impact the company's ability to raise capital in the future.¹ Thus, the income stream from preferred shares is still subject to the financial health of the issuing company.

Investing in common shares offers a different set of advantages for investors. A primary benefit is the voting rights that typically accompany common stock ownership, allowing shareholders to participate in important company decisions, including the election of the board of directors.² This provides investors with a say in the company's governance and strategic direction. Common shares also offer the potential for significant capital gains, as their value can increase substantially if the company performs well, and its earnings grow.² This makes common stock attractive for investors seeking long-term growth. Holders of common stock directly benefit from the company's growth and increased profitability², aligning investor returns with the company's success. While not guaranteed, successful companies often distribute a portion of their profits to common shareholders in the form of dividends², providing an additional source of return. Common shares are also generally more frequently traded and have higher liquidity compared to preferred stock², offering greater flexibility for investors to manage their investment positions.

However, investing in common shares also comes with its own set of disadvantages. Dividend payments to common stockholders are not guaranteed and can fluctuate or even be suspended depending on the company's financial performance and the decisions made by its board of directors.² This makes the income stream from common shares less predictable compared to the fixed dividends of preferred shares. Common stock prices tend to be more volatile and can decline significantly during company downturns or economic recessions¹, exposing investors to a greater risk of capital loss. In the event of a company's liquidation, common stockholders have the lowest priority in receiving any remaining assets, being paid only after all creditors, bondholders, and preferred shareholders have been fully compensated.² This represents a higher risk of losing the entire investment in case of bankruptcy. Furthermore, the issuance of new common shares by a company can lead to dilution, reducing the ownership percentage and potentially the earnings per share of existing shareholders.⁹ This means that the value of existing shares might be negatively impacted over time as the total number of outstanding shares increases.

Company Perspective: Reasons for Issuance

Companies choose to issue preferred shares for a variety of strategic financial reasons. One key motivation is to raise capital without diluting the control of existing common shareholders.⁷ By issuing preferred stock, companies can obtain equity financing without granting voting rights to new investors, allowing founders and existing shareholders to maintain their control over the company's decisions. In some cases, the cost of capital associated with issuing preferred shares can be lower than that of issuing common equity.¹³ Preferred dividends may be lower than the expected return that common stockholders demand, making preferred stock a more cost-effective way to raise funds. Preferred shares also offer companies flexibility in managing their dividend payments. Unlike interest payments on bonds, which are typically mandatory, companies can suspend preferred dividend payments if they face financial difficulties without the immediate risk of default.¹³ However, it is important to note that for cumulative preferred stock, any missed dividends must eventually be paid. From a balance sheet perspective, preferred stock is considered equity, not debt.¹³ Issuing preferred shares can therefore help companies maintain a lower debt-to-equity ratio, which is often viewed favorably by investors and lenders as it indicates lower financial leverage. The specific features of preferred stock, such as fixed dividends and liquidation preferences, can also make them attractive to certain types of investors, particularly institutional investors and those seeking a steady income stream.¹ This can broaden the company's investor base and improve access to capital. For financial institutions, such as banks, preferred stock can also count towards regulatory capital requirements, helping them meet necessary capital adequacy ratios.¹³ In some instances, preferred stock can be used as a strategic tool in takeover defenses. By structuring preferred shares with high liquidation values that become payable upon a change in control, companies can make themselves less attractive targets for hostile takeovers.¹⁶

Companies issue common shares primarily as a means of raising equity financing to fund various business activities, such as expansion, research and development, acquisitions, and repaying debt.¹⁸ Unlike debt financing, raising capital through the issuance of common stock does not require the company to make regular interest payments or repay the principal amount, providing greater financial flexibility. Offering ownership in the company through common shares can also help align the interests of investors with the company's long-term success, potentially fostering greater commitment and support.¹⁸ For founders and early investors, issuing common stock can eventually provide an opportunity to realize a return on their initial investment through public offerings or private sales of their shares.⁹ When a private company goes public by issuing common stock through an initial public offering (IPO), it often experiences an enhanced public image and increased credibility in the market.²⁷ This can lead to greater customer trust and new business opportunities. Companies also frequently use common stock as part of their compensation packages to attract and retain talented

employees, often in the form of stock options or grants, which aligns employee interests with the company's performance.²⁸ In the context of mergers and acquisitions, a company can use its own common stock as a form of currency to acquire other companies, allowing it to make acquisitions without significant cash outlays.¹⁸ Similar to preferred stock, issuing common stock increases the company's equity base, which can improve its debt-to-equity ratio, making it appear more financially stable to investors and creditors.²⁷

Comparative Analysis of Risk and Return Profiles

The risk and return profiles of preferred and common shares differ significantly, making them suitable for investors with varying objectives and risk tolerances. Preferred shares generally exhibit a lower risk profile compared to common stock but are considered riskier than bonds.¹ This lower risk is primarily due to their lower price volatility compared to common stock², the priority of their dividends over common stock dividends¹, and their higher claim on assets than common stock in the event of liquidation.¹ However, preferred shares are subject to interest rate risk, meaning their prices tend to move inversely to changes in interest rates¹, and they typically have lower liquidity compared to common stock.² The return profile of preferred shares is primarily focused on providing a steady stream of income through their typically fixed dividend payments.¹ While some preferred shares, particularly convertible ones, offer the potential for some capital appreciation², the overall return potential of preferred shares is generally lower than that of common stock over the long term.² This makes preferred shares more suitable for investors who prioritize income and stability over high growth.

Common shares, on the other hand, are generally considered to have a higher risk profile compared to both preferred stock and bonds.¹ Their price volatility is higher, as they are more sensitive to company performance and overall market conditions.¹ Dividends on common shares are not guaranteed and are paid only after preferred shareholders receive their dividends.² Furthermore, in the event of liquidation, common shareholders have the lowest priority in claiming any remaining assets.² Despite these higher risks, common shares offer the potential for significant capital gains and long-term growth.² While dividend payments are not assured, they can provide an additional source of return for investors. Historically, common shares have tended to outperform bonds and preferred shares over the long run.² The risk and return profile of common shares makes them more suitable for investors with a higher risk tolerance who are seeking long-term capital appreciation.

| Feature | Preferred Shares | Common Shares |
|---------|------------------|---------------|
|---------|------------------|---------------|

| | | |
|--------------------------------|---------------------------|-------------------------------|
| Dividend Priority | Higher | Lower |
| Dividend Type | Typically Fixed | Variable |
| Voting Rights | Generally Limited or None | Typically, One Vote Per Share |
| Liquidation Preference | Higher than Common | Lowest |
| Capital Appreciation Potential | Lower | Higher |
| Price Volatility | Lower | Higher |
| Risk Level | Moderate | Higher |
| Potential Return | Moderate (Income Focus) | Higher (Growth Focus) |

Conclusion

In summary, preferred and common shares represent distinct forms of equity ownership with differing characteristics that cater to various needs of investors and companies. Preferred shares offer a blend of fixed income and equity features, providing dividend priority and a higher claim on assets compared to common shares, but typically lack voting rights and have lower growth potential. They are well-suited for income-seeking, risk-averse investors and serve as a valuable tool for companies to raise capital without diluting common shareholder control. Conversely, common shares represent the fundamental ownership stake in a company, granting voting rights and offering the potential for significant capital appreciation, albeit with higher risk and dividend uncertainty. They are ideal for investors with a higher risk tolerance seeking long-term growth and are the primary means for companies to raise equity financing and align shareholder interests. The decision to invest in preferred or common shares, or for a company to issue them, hinges on a careful consideration of individual investment objectives, risk tolerance, and the strategic financial goals of the corporation.

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