A Simple Model

LBO: Common Stock + Preferred Stock

NOTES TO ACCOMPANY VIDEOS

These notes are intended to supplement the videos on ASimpleModel.com. They are not to be used as stand-alone study aids, and are not written as comprehensive overviews of the topic detailed. The purpose of these notes is to provide a tangible collection of the visuals used in the videos with comments highlighting the more important aspects covered.

This video covers the benefits of including preferred stock in the equity structure of a transaction. Before elaborating on the explanations provided in the video, I thought it would be helpful to revisit the definitions of preferred stock introduced previously.

In a prior video we introduced preferred stock and convertible preferred stock. In this recent installment we introduce redeemable preferred stock. Definitions follow:

- Preferred Stock – A class of ownership that has a claim on the assets and earnings of a business ahead of common stock. Preferred stock is issued with a face value and generally pays or accrues a dividend as a percent of face value.
- Convertible Preferred Stock – If the shares of preferred stock issued are convertible, it means that at the option of the security holder, or the option of the board of directors, or at a predetermined date, the preferred stock shares can be converted into shares of common stock.
- Redeemable Preferred Stock (also referred to as "callable") – If the shares of preferred stock issued are redeemable, it means that the issuer (the company) can buy them back at a defined price, which is typically par value. In such an event, any accrued and unpaid dividends are generally paid out as well.

Preferred stock is a flexible security that offers many options, but in all cases it's important to bear in mind that preferred stock is always senior to common stock. Understanding this relationship is critical to understanding the advantages of including preferred stock in the capital structure.

Advantages of Preferred Stock:

First: That preferred stock has the advantage of making the common stock "cheaper." This is explained in the video by pointing out that preferred stock's claim on the business is limited to the par value of the stock and the associated dividend. In this scenario, where the preferred stock does not have additional upside, it is similar to including an additional tranche of debt. This means that all of the upside remaining can be captured by the common stock shareholders for a significantly smaller sum.

This structure provides an advantage as it relates to rewarding the management team. By providing the management team the opportunity to buy "cheaper" shares, management team members will realize capital gains and be taxed accordingly. Without this structure, the common stock might require too much out-of-pocket capital for the management team to find it attractive. In the latter scenario it is more likely that the equity awards offered will be taxed as ordinary income (i.e. taxed at much higher levels).

Second: Redeemable preferred stock provides the sponsor with the option of requiring the company to buy back the preferred stock, which results in a partial return of capital. Within the industry, this is known as "de-risking the investment" or "taking chips off the table." The incredible benefit, however, is that the sponsor maintains all of the upside through ownership of the "cheaper" common stock.

To help visualize this, imagine two potential investment scenarios requiring that you personally make a $1,000,000 investment.

1. **Common Stock:** All capital is invested as common stock. Over a 7 year hold period the investment generates a return of 3.0x the capital invested and an IRR of 17%.
2. **Common Stock + Preferred Stock:** $100,000 is invested as common stock and $900,000 is invested as redeemable preferred stock (assume no dividend for simplicity). In year 5 there is sufficient liquidity to safely redeem the preferred stock, and you receive a distribution of $900,000. The business achieves the same results, and in year 7 you receive $2,100,000. The investment again generates a return of 3.0x the capital invested, but the IRR is boosted to 19%. You also have the advantage of having capital returned sooner, which you can then redeploy.

If both panned out as described, hopefully between the two you would find the second option more attractive.

Please be sure to watch the video for greater context, and as always, the template is available for download just beneath the video player.