

When Precedent Doesn't Help: Valuing Preferred Stock Outside the Box

By Stuart Weiss, CPA/ABV

As appraisers, we always look for concrete examples and hard figures. We like to value things based on precedent and use methods that have proved their worth before. But what do you do when the hard facts don't cooperate? I was recently asked to value shares of preferred stock that I knew involved substantial risk—but risk that I couldn't quantify. I looked at textbooks and cases and comparables, but nothing seemed appropriate to this case. As a result, I felt I had to choose a "safe" route and value the security at a higher level than was perhaps appropriate, but one that I could justify.

Here's the scenario. An attorney asked me to value two types of preferred stock as well as the common stock of a large eastern Oregon ranch for gift tax purposes. The ranch itself was appraised by a real estate appraiser, so I was tasked with valuing the preferred shares and subtracting these values to arrive at the common share values. On Oct. 1, 2012, there were 1,000 shares of Series A voting preferred stock issued and outstanding. On Nov. 1, the father, who owned all of the shares, gave 49% to his son. In the same time frame, the father gave the son 49% of 2,000 shares of Series B preferred non-voting stock issued and outstanding. The father owned all 10,000 of the outstanding common shares, which he planned to give away at a later date.

The Class A and B shares were unusual in that they didn't pay a dividend. The Class A had a "stated value" of \$20 per share and could be

"retracted," or redeemed, at the option of the holder at any time. Class B, with a par value of \$1,000 per share, could be redeemed at the option of the holder at a rate of 5% per year over 20 years. The Class A preferred seemed simple enough—\$20 per share, like cash in a drawer. "I would have a hard time saying it's not worth the stated value," said Keith Meyers, shareholder with Portland, Ore.-based Perkins & Co. P.C.

Like a bond, but not a bond. The Class B preferred posed more of a challenge. With no dividends, a discounted cash flow analysis made no sense. But with the retraction feature, the calculation would involve the present value of an annuity of \$50, just like a bond. What should the discount rate be?

I consulted the major textbooks, but most only had a few pages on the valuation of preferred shares. There were a few references in *BVU* and other professional journals. However, the best source that I found was Chapter 24 in Shannon Pratt's *Valuing a Business*, fifth edition (2008). Many of Dr. Pratt's suggestions were right on point, although hard to apply in practice. At the end of the chapter, Revenue Ruling 83-120 is presented, in particular Section 4, "Approach to Valuation—Preferred Stock." The relevant statements are shown below with the challenges they presented:

In general, the most important factors to be considered in determining the value of preferred stock are its yield, dividend coverage and protection of its liquidation preference.

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In the subject company's case, there is no dividend. The liquidation preference and the yield will be discussed in the next sections.

A publicly traded preferred stock for a company having a similar business and similar assets with similar liquidation preferences, voting rights and other similar terms would be the ideal comparable for determining the yield required in arms length transactions for closely held stock. Such ideal comparables will frequently not exist. In such circumstances, the most comparable publicly traded issues should be selected for comparison and appropriate adjustments made for different factors.

Since ranches aren't typically public companies, I went to the NAREIT web site (reit.com) to see whether any real estate investment trusts invest solely in agriculture. I didn't find any. I called the trade organization's national headquarters in Washington, D.C., and spoke with an analyst who told me that there were no such REITs. As an alternative, I selected REITs in any area of real estate that also issued preferred stock. I found 10. However, the preferred shares, though technically public, did not have publicly available prices, trading more like restricted stock. Therefore, I was unable to determine their yields to maturity, instead using coupons.

I had to make the somewhat far-fetched assumption that all of the preferred shares traded at par. I made a list of the 10 preferred shares, and determined that the median coupon was 7%, ranging from about 5% to 9%. I selected 9%, reasoning that the risk associated with the worst REIT would still be less risky than an investment in my subject company, which required the assumption that the subject would be able to redeem the preferred shares over the next 20 years without running into cash-flow challenges. In truth, I believe that the discount rate should be much greater than 9%, but I have no data to back up that assertion. As a result, I valued the Class B shares as the present value of a \$50 annuity over 20 years, or \$456.

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Whether the issuing corporation will be able to pay the full liquidation preference at liquidation must be taken into account in determining fair market value. This risk can be measured by the protection afforded by the corporation's net assets. Such protection can be measured by the ratio of the excess of the current market value of the corporation's assets over its liabilities to the aggregate liquidation preference. The protection ratio should be compared with the ratios for high quality preferred stock to determine adequacy of coverage. Inadequate asset protection exists where any unforeseen business reverses would be likely to jeopardize the corporation's ability to pay the full liquidation preference to the holders of the preferred stock.

According to a real estate appraisal, the ranch's fair market value was about 15 times the preferred stock obligation. Therefore, I did not consider the liquidation issue a significant risk factor.

Another factor to be considered in valuing the preferred stock is whether it has voting rights, and if so, whether the preferred stock has voting control.

Although the Series A preferred shares issued by the company are voting, the gift was a minority interest. Therefore, I didn't assign additional value to it. But even if I did assign a value, it would have been a guess because I don't know how much benefit to assign.

Divided opinions from the experts. I consulted with several BV professionals around the country who value preferred shares, and they weighed in on my approach for this article, although not for the valuation engagement itself. For Sean Saari, a CPA/ABV with the CPA firm of Skoda Minotti in Cleveland, valuing preferred shares becomes a factor in complex capital structures where preferred is convertible into common shares. "The preferred is usually just a piece that we're backing out to get to a common value unless the preferred shareholders are better off converting to common," he notes.

Richard Wise, FASA and partner with MNP LLP in Montreal, objected to my using 9%. "REITs are publicly traded. This subject company is closely held and there is no market for the shares. Secondly, you're assuming a payout over 20 years, so that's another risk factor. The discount rate has to be much higher than 9%."

Mark Krickovich, owner of MK Appraisal Group Inc. in Portland, Ore., and Sacramento, Calif., says that because of the risk that the preferred stock won't be redeemed upon liquidation, "it's entirely possible that you have overvalued the preferred." Somehow, I have to adjust very imperfect public data, similar either to the process by which guideline public company multiples are adjusted to apply to the subject company or to the process of assigning additional risk percentage points to account for specific company risk.

Another valuation expert acknowledges that preferred stocks of small corporations don't have a lot of hard data upon which to make a valuation. "This is where experience and being a valuation person for a long time comes into play," he said. "There's no place you can go to find a formula that you can plug in. If that's what you're trying to do, then I can't help you."

In conclusion. We can all agree that valuation assignments usually don't lend themselves to a nice and neat quantitative solution, and my experience valuing this preferred stock is a great example of this truth. Ultimately, I felt uneasy valuing the B shares below \$456. Any discount rate above 9% would have required me to introduce what was uncomfortable subjective evidence that I didn't feel I could substantiate in a potential audit.

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