

MIPS offer attractive yields relative to corporate bonds and conventional preferreds, but that needs to be balanced against interest rate risk, redemption features, and tax status.

Hybrid Securities: A Basic Look at Monthly Income Preferred Stock

By Robert T. Kleiman and Anandi P. Sahu

Over the past decade, the preferred stock sector has become one of the most innovative on Wall Street. In October 1993, Goldman, Sachs & Co. created monthly income preferred securities, or MIPS. MIPS, which are also termed hybrid preferred stock, are attractive to issuers because they offer the tax-deductibility of debt combined with some equity credit from the rating agencies. The instruments are aimed at individual investors who seek income, and they have become so popular that they accounted for more than 70% of all the preferred stock issued by corporations to the public in 1995.

Basic Structure

Technically, MIPS are shares of preferred stock issued by a special purpose foreign or domestic limited-life company (LLC). The LLC, in turn, is a wholly owned subsidiary of a U.S. parent corporation. The parent borrows the proceeds from the LLC and then pays interest to the subsidiary on that loan. The payments in turn are paid to MIPS holders in the form of dividends. The instruments can best be seen as subordinated debt issued by the parent and repackaged as preferred stock.

Here's the sequence of events in which MIPS issues are created:

- The parent creates a 100%-owned subsidiary, the limited-life company (LLC). Originally, all the LLCs were set up in Turks, Caicos, and Cayman Islands. In 1994, however, the Securities and Exchange Commission issued a series of no-action letters enabling domestic LLCs to also be used in creating MIPS.
- The LLC sells MIPS to individual investors. Corporations generally do not purchase MIPS since the dividends received from MIPS do not qualify for the standard 70% dividend exclusion allowed to corporations.

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- The proceeds from the sale of the MIPS are transferred to the parent in the form of a loan by the LLC.
- Dividends on the MIPS are payable to security holders on the last day of each calendar month. The funds to pay the dividends are generated from interest payments made by the parent to the LLC for the loan.

The MIPS structure is designed to satisfy two primary objectives. First, the parent corporation claims tax deductions for the interest payments on the loan from the LLC. Because the LLC is recognized as a partnership for tax purposes, it acts as a tax conduit so that the full amount of the interest payments on the loan flows through to holders of the MIPS. Second, MIPS are considered by the rating agencies to be part equity, since the dividends can be deferred without triggering default.

In evaluating the security, the rating agencies treat MIPS as being closer to equity than debt. In fact, Moody's and Standard & Poor's assign most investment grade issuers of MIPS equity credit of 70%-85% in the computation of financial ratios in assessing solvency of the issuer.

Originally, MIPS were issued with maturities as long as 100 years. However, the Clinton administration floated proposals that would have denied interest deductions for MIPS. Accordingly, more recent issues have significantly shorter maturities in the 30-50 year range. However, the maturity issue is far from settled. Recently, the Clinton Administration proposed eliminating the tax deductibility of dividend payments on MIPS with a maturity of 15 years or more. If this proposal is adopted, MIPS maturities will likely shrink even more (to less than 15 years) in the future. At the maturity of the loan between the parent corporation and the LLC, the MIPS are redeemed.

MIPS are typically listed for trading on the New York Stock Exchange similar to regular preferred stock. MIPS issuers have included such recognizable names as Texaco, Corning, GTE, and Aetna. Insurance and utility companies, both of which have traditionally relied on preferred stock as a significant component of capital, have accounted for about 60% of MIPS issues.

Advantages of MIPS

From the issuer's point of view, the securities combine the traditional benefits associated with equity capital with the tax-deductible structure normally limited to debt financing. The cost savings for the corporations issuing MIPS can be significant when compared to conventional preferred stocks. Furthermore, these tax-related savings are obtained without raising the corporation's debt ratio. As a result, companies—such as RJR Nabisco—have undertaken preferred stock exchange offers with increasing frequency. The exchanges allow the issuer to redeem their existing preferred stock and replace it with tax-deductible MIPS.

From the investor's point of view, MIPS offer several advantages. The securities typically offer a higher yield than alternative investments such as certificates of deposit and money market funds. Investors seeking current income are also attracted to MIPS for the monthly dividend payment schedules. MIPS provide a convenient vehicle for individual investors to invest in instruments that are similar to long-term corporate debt. Previously, individual investors with relatively small amounts to invest have lacked this opportunity because corporate debt is typically sold in \$5,000 lots (i.e., a minimum purchase of five \$1,000 bonds). MIPS, by contrast, cost only \$25 each. Thus, they open the fixed-income market to more individual investors. Furthermore, there is a liquid secondary market for these securities.

These hybrid preferred securities also provide a higher yield than corporate bonds and conventional preferred stock. The yields on conventional preferred stock tends to be driven down by corporate investors, who can deduct up to 70% of the dividend payments from their corporate income tax. For that reason, conventional preferred stock holds less appeal to individual investors who are unable to deduct any of the dividend payments. This deduction,

however, is unavailable to corporate investors who invest in MIPS, which in turn makes them more favorable to individual investors.

Table 1 summarizes the rates of return on MIPS in comparison to corporate bonds and conventional preferred stock with a comparable rating from Standard & Poor's for both June and December 1996. In June 1996, MIPS offered yields approximately 0.50% higher than comparably rated corporate bonds. In December 1996, the yield spread between MIPS and corporate bonds widened to approximately 1.00%.

MIPS offered a 0.67% yield differential above conventional preferred stock for A-rated issues in June 1996, and a 0.39% yield differential for BBB-rated issues. In December 1996, the yield spread between MIPS and conventional preferred stock was 0.84% for A-rated issues and 0.40% for BBB-rated issues. The spread is larger for the higher-rated A issues because corporate investors in conventional preferred stock prefer higher-grade securities. Accordingly, these investors bid up the prices of A-rated conventional preferreds, pushing down the yields on these securities.

Disadvantages of MIPS

Although MIPS have several advantages, they do have some negative features. The securities do not possess the same level of investment security as corporate bonds. MIPS are generally subordinated to all of the parent corporation's debt, making the MIPS more risky. Unlike a bond, the dividend payments on MIPS can be temporarily suspended if the company experiences cash flow difficulties. In this regard, these securities are similar to conventional preferred stock, which can also suspend dividend payments.

MIPS can typically suspend dividend payments for as long as five years, although the company would first have to stop paying dividends on its common and conventional preferred stocks. In the event that the dividend payments are deferred, the investor is still taxed on the "phantom income" as if it had been received in the current period.

Another difficulty is that the market values of MIPS fluctuate with the bond market as prevailing interest rates change. Also, most issues include redemption features that allow the issuer to redeem the securities after five years. The redemption provision limits upside market price potential but does not provide a corresponding guarantee of a minimum price.

MIPS also expose the investor to a certain degree of tax risk. To date, the IRS has permitted the favorable tax treatment of MIPS, allowing corporations to treat the interest payments to the LLCs as deductible expenses. There is always the risk, however, that the IRS may decide to disallow this treatment. In order to protect against such an occurrence, many MIPS issues include provisions that allow the corporation to redeem the shares in the event that the IRS is successful in challenging the securities' tax status.

Table 1.
Yields Compared

Rating	Bond Yields by Rating	MIPS Yields by Rating	Conventional Pfd. Stock by Rating
	June 1996 (%)	June 1996 (%)	June 1996 (%)
A	7.83	8.31	7.64
BBB	8.18	8.67	8.28

Rating	Bond Yields by Rating	MIPS Yields by Rating	Conventional Pfd. Stock by Rating
	Dec. 1996 (%)	Dec. 1996 (%)	Dec. 1996 (%)
A	7.21	8.25	7.41
BBB	7.50	8.51	8.11

Source: Standard & Poor's Bond Guide and Standard & Poor's Stock Guide

Table 2.
Advantages and Disadvantages of
Monthly Income Preferred Stock

Advantages

- Provides higher yields than CDs, money market funds, and corporate bonds.
- Accessible to retail investors; par value is \$25.

Disadvantages

- Generally subordinated to all of the parent corporation's debt.
- Can suspend dividend payments for up to five years.
- Market values fluctuate with interest rates.
- Investor may be exposed to tax risk.
- Tax filings use Form K-1 (rather than 1099).

Finally, MIPS also require more complicated and costly tax filings by investors because dividends paid on MIPS are reported on a partnership tax form (K-1), rather than the standard 1099 ordinarily used for dividends. A K-1 is required because the MIPS are technically issued by the LLC, which is viewed as a special purpose partnership for

tax purposes.

Table 2 summarizes the advantages and disadvantages of MIPS.

Variations on MIPS

To simplify the tax reporting requirements, investment bankers developed a new hybrid preferred structure. With this new form of MIPS, termed trust originated preferred securities (or TOPrS), the corporation issues the securities from a trust rather than an LLC. In 1995, Merrill Lynch managed the first TOPrS transaction, an exchange offer for an outstanding straight preferred issue for SunAmerica. With TOPrS, investors receive annual tax-reporting information on Form 1099 rather than the K-1. In addition, these instruments pay dividends quarterly (the typical period for dividends) rather than monthly.

Table 3 summarizes the major features of MIPS and TOPrS.

Subsequently, Goldman, Sachs & Co. created a clone to trust originated preferred securities, termed quarterly income preferred securities (or QUIPS). Some QUIPS issues give the issuer the right to change the maturity of its QUIPS at any time, which enhances the flexibility of the securities. For example, in an issue developed for MCI, the QUIPS begin with a 30-year maturity, which the issuer may extend to as long as 49 years, or reduce to as short as the five-year non-call period.

Other variations of the basic MIPS structure include adjustable-rate MIPS and convertible MIPS. The dividend rate on adjustable-rate MIPS floats in line with prevailing interest rates, whereas convertible MIPS may be converted into the issuer's common stock at the option of the security holder.

Another modification is exchangeable preferred income cumulative shares (or EPICS), which permits the parent to redeem the MIPS for its preferred stock.

Table 3.
A Comparison of Hybrid Preferred Structures

	MIPS	TOPrS
Legal Form of Issuer	U.S. or offshore partnership	Delaware business trust
Security Offered	Preferred security representing limited partnership interest	Preferred security representing interest in beneficial trust
Payment Frequency	Monthly	Quarterly
Par Value	\$25	\$25
Tax Reporting	Schedule K-1	Form 1099
Cumulative	Yes	Yes
Maturity	30 to 49 years	30 to 49 years
Call Features	Non-callable for five years	Non-callable for five years
Dividend Deferral	Up to five years	Up to 20 consecutive quarters
Tax on Deferred Payments	Yes	Yes
Rank in Capital Structure	Subordinate to senior debt; senior to preferred stock	Subordinate to senior debt; senior to preferred stock
Company Exchange Option to Debt	Yes	Yes
Deduction Eligible for Dividend Received (Corporations Only)	No	No

Analyzing Data

Prior to purchasing MIPS, QUIPS, or TOPrS, the individual investor should obtain the original prospectus from the issuer

and become familiar with the features associated with the security. The investor should initially focus on “plain vanilla” securities rather than adjustable rate or convertible MIPS, which are more complex to analyze.

Information on MIPS and other hybrid preferred stock issues can be obtained on a daily basis from the Wall Street Journal. The specific securities are listed in the “New York Stock Exchange Composite Transactions” section. Although separately identified, MIPS issues are combined with the traditional common and preferred stock issues of listed firms rather than being recorded in a separate table. For example, let’s look at the following entry for the MIPS issued by Texaco:

24 22³/₈ Texaco MIPS 1.72 7.3...141 23⁵/₈ 23¹/₂ 23⁵/₈ + ¹/₈

The first number, 24, represents the 52-week high price. The second number, 22³/₈, represents the 52-week low price. Next, the name of the issuer (Texaco) and the security (MIPS) are indicated. The following number, 1.72, is the annual dividend amount, and 7.3 denotes the annual dividend yield in percent. The next figure 141, represents the daily volume in 100s of shares. The next two numbers (23⁵/₈ and 23¹/₂) denote the daily high and low price. Finally, 23⁵/₈ represents the daily closing price, which is up ¹/₈ over the previous day’s close. Similar entries are provided for TOPrS and QUIPS issues.

Monthly information on MIPS, QUIPS, and TOPrS is provided in Standard and Poor’s Monthly Stock Guide. Here, hybrid preferred issues are compiled in the “Preferred Stock Summary” section and combined with traditional preferred issues. In addition to the data on price and annual dividend provided in the Wall Street Journal, the S&P Stock Guide provides information on the ex-dividend date, the rating of the hybrid preferred issue, the call price and first call date.

The securities are best analyzed as fixed-income alternatives. First, the investor should determine that there is a

positive yield spread between the hybrid preferred shares and both conventional preferred stock and the subordinated debt of the same issuer. Next, the investor should evaluate the likelihood that the issuer will continue to make the dividend payments on a regular basis rather than deferring them. Therefore, the purchaser should avoid issues that are experiencing cash flow difficulties and/or issues that might experience downgrade in their credit rating. Investors may desire to concentrate on those issues rated A rather than BBB because they are less likely to develop cash flow difficulties. In addition, the yield spread between MIPS and conventional preferred shares is higher for A-rated issues than for BBB issues. An early warning sign of a potential downgrade in the credit rating may be found by examining Standard and Poor’s Bond Guide for bond issues that have been placed on the “Credit Watch” list for possible downgrading. If a firm’s bonds have been placed on this list, the investor should avoid or sell the issue.

Summary

Monthly income preferred securities (MIPS) are geared as a fixed-income alternative for retail investors. They offer an attractive yield that is higher than that obtainable on either corporate bonds or conventional preferred stock. However, these securities do not possess the same level of investment security as corporate bonds.

In addition, most issues include redemption features that allow the issuer to redeem the securities after five years, and the market values of the instruments fluctuate with interest rates.

MIPS also require more complex tax filings because dividends paid on MIPS are reported on a partnership tax form (K-1), rather than the standard 1099. To alleviate the tax filing requirements, Merrill Lynch created trust originated preferred securities (or TOPrS), whereby firms issue the securities from a trust rather than an LLC. 