WHY FIRMS ISSUE NON-CONVERTIBLE PREFERRED STOCK

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In a Miller and Modigliani (1958) world capital structure and financing choices are irrelevant. However, once market imperfections are introduced to the model, the irrelevance argument fails. Market imperfections have been used to explain why a firm chooses a certain mix of debt and equity; however, rarely is preferred stock considered in this context.

This study uses a two-stage event study to examine why firms issue preferred stock. First, we estimate an equation explaining the issue/no issue decision using probit. Second, we model the capital structure component decision of common stock, debt or preferred stock. The model is tested using multinomial logit.

Examining security issues from two separate time periods, the results indicate a potential linkage between the two decisions, implying the need to examine the two equations in a nested context. The results also show how market imperfections affect the preferred stock decision by examining both the preferred stock vs. common stock decision and the preferred stock vs. debt decision. A valuable by-product to the analysis is an examination of factors affecting the common stock vs. debt decision.