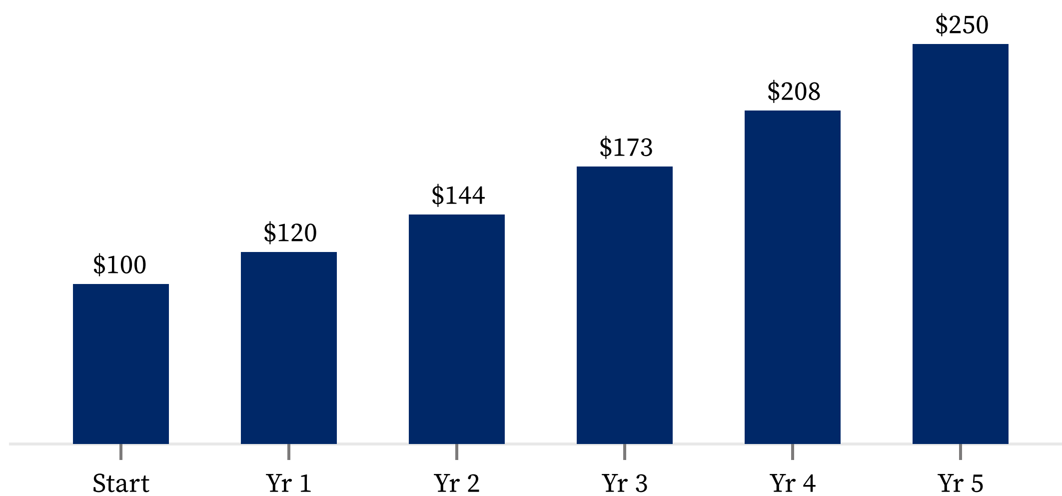
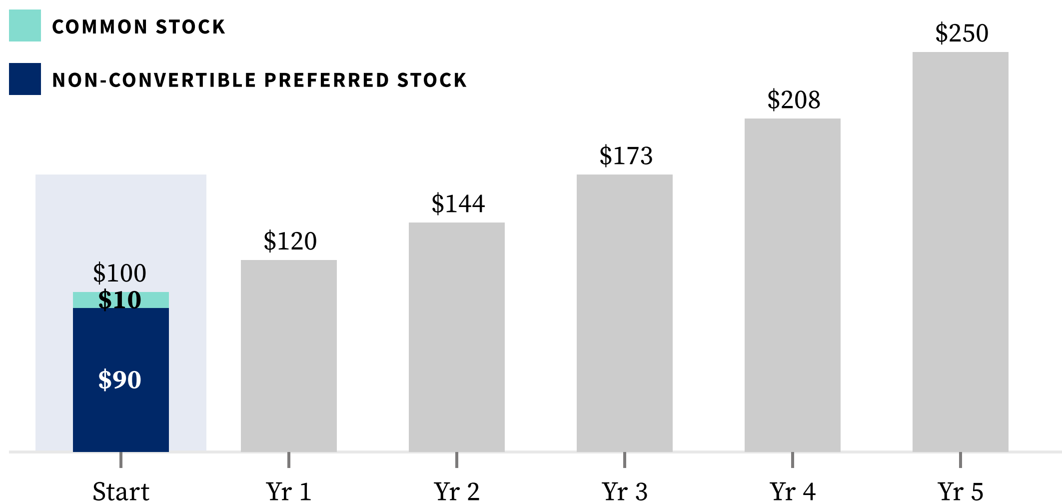
Deep Dive #1: Preferred/Common Structure

This section provides an illustrative example of the intent and impact of the executive compensation structure mentioned earlier which is the basis of our proposal (but for the benefit of workers).

Let's imagine there is a company called Jane's Pet Food whose equity value (meaning the total value of all of its shares) is $100 million. And let's say that the company's growth prospects are strong and that the expectation is that the equity value will increase from $100 million initially to $250 million in 5 year's time.



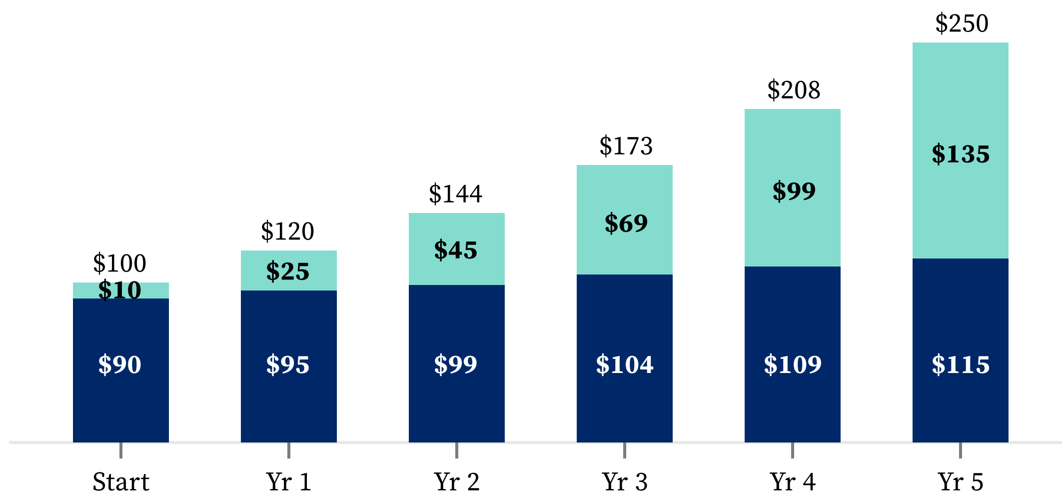
Next, let's assume we divide the initial $100 million of equity value into two components, $10 million of common stock and $90 million of non-convertible preferred stock (the reason for this split will become clear).



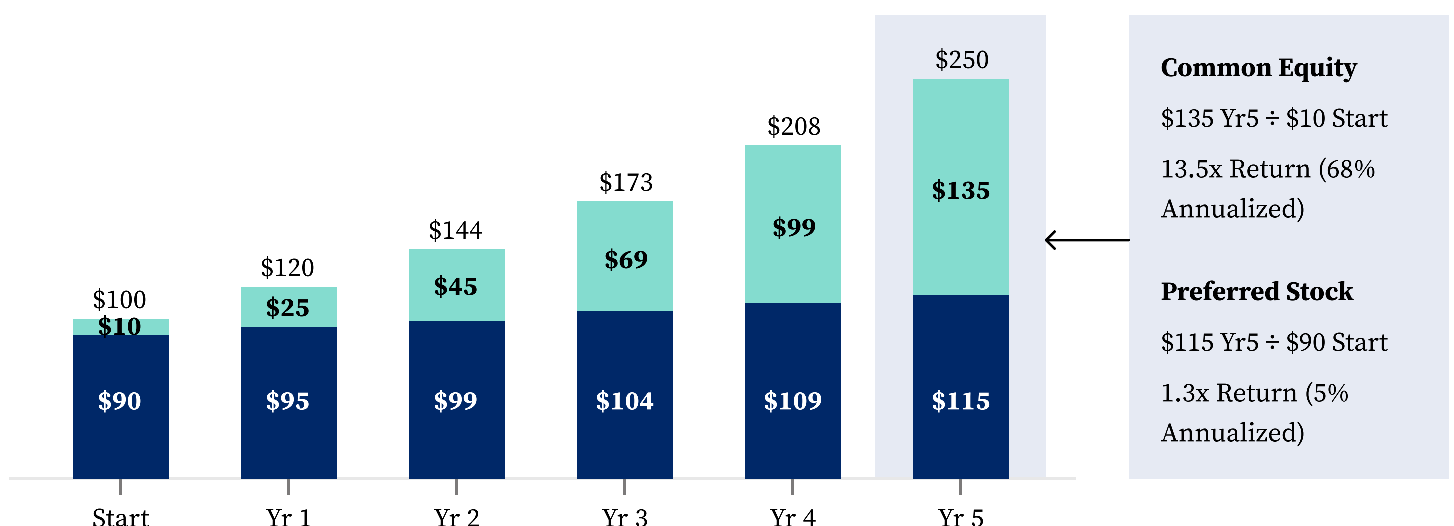
In this structure, the "non-convertible preferred stock" simply acts like a loan where interest is paid in-kind rather than in cash. As we will show, it has an intentionally low rate of return to allow the common equity to have an outsized rate of return.

The preferred stock is worth $90 million at the outset and will increase in value at a fixed rate, let's say 5%. Importantly, it has no ability to participate in the value created at the company beyond this 5% rate, no matter how well the company performs. In finance terms, it has "capped upside".

The common equity therefore receives all of the value beyond the annual 5% return on the preferred stock. So, if the value of Jane's Pet Food increases from $100 million to $250 million (as outlined earlier), the outcome for each of the common stock and the preferred stock is as follows:



As shown above, the $90 million of preferred stock increases by 5% per year and reaches $115 million of value by year 5 (a 1.3x return). This relatively low, fixed return for the preferred stock allows for the vast majority of the return to flow to the common equity, which increases from $10 million all the way to $135 million (a 13.5x return)



Now, back to how companies have used this to compensate senior executives -- what does this structure achieve? It allows the company to sell (or gift) a small percentage of the total equity for a small amount of money while providing enormous financial upside to the executives (note: there are also tax benefits to this structure which are not relevant to this discussion).

In our example, let's assume the CEO was allowed to purchase 10% of the common equity without being required to purchase any of the preferred stock. This would only cost $1 million up-front but, assuming the company reached its projections, would yield a $13.5 million return.

Had the same $1 million been invested up-front without such structuring, it would have yielded a $2.5m million return. Simply put – this structure enabled a common equity investor to generate 5x+ more profits than they could have achieved otherwise.

As noted in the section titled "Our Proposal", the idea is to leverage this clever piece of financial engineering for the benefit of workers, effectively "supercharging" their returns despite a relatively small day 1 value.