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THE IMPACT OF US TAX REFORM ON CORPORATE STRATEGY AND M&A

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The new 21% US corporate tax rate and the mandated repatriation of $1.5 trillion to $2 trillion of overseas cash have received lots of media attention, as they should. But the more significant implications of the 2017 Tax Cuts and Jobs Act are found behind the headlines. It's clear that the tax reform incentivizes a new pattern of investment that will likely have profound implications for companies, particularly with respect to M&A. Portfolio restructuring and divestitures are now much more attractive for sellers; there are modest benefits for some buyers as well. When combined with an unprecedented level of corporate liquidity, these incentives have significant potential to reshape corporate portfolios, provided buyers and sellers can overcome the new big uncertainty that the regime introduces—its own duration.

The most significant provisions of the new law include a reduction in the corporate tax rate from 35% to 21%; mandatory repatriation of offshore cash, with a one-time tax of 15.5%; immediate expensing of investment in tangible business property; and new limits on interest deductibility. We expect these changes to result in the following:

- Increased corporate earnings power and quality, as well as liquidity, will create a more stimulative investment and M&A environment.

- Higher earnings power will make year-end 2017 valuations look less lofty.

- Lower taxes will increase the number of noncore asset sales—either direct sales or two-part transactions in which buyers acquire portfolios and then sell the assets they don't want.

- Capital allocation decisions, particularly those involving the choice between making new investments and returning cash to shareholders, will move to the forefront thanks to an unprecedented level of corporate liquidity. Activist investors, as well as corporate managers, will be paying close attention to this topic.

- Debate over the longevity of the new tax levels will inject new uncertainty into dealmaking because asset values and capital allocation decisions are both affected by the prospective number of years that the law's key provisions remain in effect.

Here's our take on each of these implications.

The Stimulative Effect

Six months ago, companies were cautious. Valuations looked inflated. Management teams questioned how much longer the recovery could last. The arrival of a new administration that promised change in such areas as taxes, regulation, and trade injected substantial uncertainty into the business environment. It was not the best time to make big bets.

The new tax law provides some clarification. Lower taxes and cash repatriation will put an unprecedented level of liquidity into the hands of either corporations or their shareholders—and encourage companies to make the investment decisions that were put on hold as executives took stock of the changing environment.

Valuations Appear Less Lofty

Lower taxes and higher earnings make the 2017 year-end market valuations, which many thought to be high if not overheated, appear more in line with historical norms, at least for a while.

Under 2017 effective tax rates (about 27%), the S&P 500's one-year-forward P/E ratio was 18.4, well above historical averages. By the end of 2017, BCG's ValueScience Center began to observe substantial gaps between company valuations and their fundamentals. Other indicators showed similar signs; the Shiller P/E, for example, approached levels seen only twice before—in 1929 and in 2000.

The tax changes will increase after-tax earnings. For the S&P 500, we think the increase will be on the order of 12% to 16% as effective tax rates decline from approximately 27% to somewhere in the range of 15% to 18%. The earnings increase results in a 10% to 15% drop in the S&P 500's P/E ratio, bringing it much closer to historic norms and to the values merited by the fundamentals. In this light, year-end 2017 valuations appear far less lofty than they did.

Lower Taxes on Asset Sales and Divestitures

The 21% rate on corporate capital gains takes a lot of the tax bite out of M&A. At 35%, a deal needed substantial synergies to overcome the tax bill, especially for fully depreciated assets. At the old rate, taxes forced companies to either live with their noncore assets or devise complex deal structures to avoid a big hit. Under the new rate, after-tax proceeds from asset sales will increase by up to 22%, depending on the asset's tax basis. With this change, deals can be assessed with greater emphasis on their business and financial merits and less concern for Uncle Sam's share of the gains.

This change has some big implications. For one, straight asset sales become a lot more attractive for both sellers and buyers. The lower tax rate for sellers will cause many companies to think differently about assets that were previously too tax inefficient to sell or too difficult or complex to spin off. We'll still see plenty of spinoffs (paying no tax is better than paying some tax), but taxable sales are now a much more viable alternative.

At the same time, buyers that are looking for a particular asset or business can much more efficiently acquire an entire company and sell off the pieces they don't want. Higher cash flows and borrowing capacity—one investment bank estimates an increase of 12% in cash flow for the median US company—give buyers added liquidity and flexibility. Companies in asset-heavy industries get an extra tax kicker—they can expense the full purchase price of tangible assets in the year of purchase. For companies in asset-heavy industries, the value of immediate expensing could be up to 3% of the purchase price.

Although we will continue to see big, headline-grabbing public-company mergers, we expect an increase in more focused asset deals that have strategic significance for both buyer and seller. We also anticipate more "parting" of portfolios (deals in which a buyer acquires a full company and then divests noncore elements) because the tax consequences of such deals are now far more forgiving. All this is good for business strategists—under the new regime, the industrial logic of consolidation, rather than tax avoidance, will drive decision making.

In contrast, deals that are structured primarily to avoid taxes, such as so-called inversions (in which a US corporation relocates to a low-tax country), will fade away. The shift to a territorial tax system and the new penalties that the tax reform law imposes on inversions will likely put an end to such transactions.

We will also see fewer highly leveraged acquisitions, including those by private equity players, because the new law limits interest deductibility to 30% of EBITDA until 2021 and restricts it further, to 30% of EBIT, thereafter. The median enterprise value/EBITDA multiple for buyouts of more than $250 million was 10.5 in the last quarter of 2017, and at that multiple and a debt-to-enterprise value of 50%, an interest rate greater than 5.7% would result in interest expenses above the 30% of EBITDA limit. In a rising interest rate environment, this may cause private equity firms and their banks to rethink leveraged buyout financing structures.

Up to $2 Trillion of Cash in Hand—but Only a Few Hands

The most striking headline number after the new 21% tax rate is the estimated $1.5 trillion to $2 trillion of US corporate cash that will now be brought home at a one-time tax rate of 15.5%. One of the more common storylines has been that this element of the tax law will lead to a groundswell of investment, particularly in M&A.

Several factors combine to undercut this hope. One is the concentrated ownership of the offshore cash in question: most of it belongs to just a few companies in two industries. About 80% is held by companies in technology and health care; ten companies, five from each sector, account for 70% of the publicly reported cash outside the US. These cash-rich companies have hardly been capital constrained. Although some managed their liquidity by borrowing domestically against their offshore cash, almost 90% of the publicly reported cash outside the US is held by companies with investment-grade ratings of A or higher.

The second is historical precedent. The 2004 Homeland Investment Act allowed a similar one-time repatriation of overseas cash at an effective corporate tax rate of 5.25%. Although the act expressly prohibited the use of funds for dividends, share repurchases, or executive compensation, studies found that the largest cash-repatriating companies did exactly that. One study found that, for firms that repatriated, a $1 increase in repatriations corresponded to a $0.60 to $0.91 increase in buybacks. There are no such prohibitions in the 2017 law, and cash-rich companies have given little indication that a new era in organic or inorganic investment will ensue.

The third factor is activism. Both portfolio restructuring and shareholder-friendly capital allocation play prominent roles in activist investors' campaigns. There is little doubt that activists are already thinking about the implications of tax reform—and little doubt that their agendas will constrain overenthusiastic reinvestment, particularly in cases where liquidity was not a constraint in the first place.

The New Big Bet Is on the Longevity of the Tax Regime

Although the new tax law ushered in some certainties, it also introduced one new uncertainty that dealmakers and corporate strategists must now wrestle with: the duration of the new tax rates. The 2017 Tax Cuts and Jobs Act was born of a narrowly divided, highly partisan political process. Its primary goals are to spur investment, boost economic growth, and create new jobs. But many economists say that the pursuit of these goals comes at a price: a big increase in the nation's debt burden. It remains to be seen how the balance between economic stimulus and fiscal deficits plays out, and these and other fundamental issues could well influence the outcomes of the 2018 and 2020 elections. Many are less enthusiastic than the current administration about the tradeoffs.

For these reasons, every investment case will need to include an implicit position on the tax outlook. Reasonable assumptions about a return to a less permissive tax regime could easily influence valuations by 10% to 20%. So far, equity valuations appear to signal a long run for the new rates, but only time will tell. It is very possible that dealmaking will become clouded by concern over how rates may or may not change in the not-too-distant future.

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