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By: **Guest Writer**
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How tax reform will drive dealmaking

***Jerome Schwartzman, David Lee** and **Winston Shows** from Houlihan Lokey discuss how tax changes will affect private equity, identifying the winners and losers.*

Tax reform has arrived in the US, and the new law dramatically alters the M&A playing field for all deal constituents, including strategics and private equity firms. After ignoring potential reform for most of 2017, dealmakers are now trying to get up to speed to assess the impact of the largest changes in decades. We believe certain industries will be affected more so than others and expect savvy investors to get ahead of the curve to capitalise on these opportunities.

Reduction in the corporate tax rate

The reduction in the federal corporate income tax rate from 35 percent to 21 percent will have widespread ramifications on M&A activity, valuations and deal structuring. Corporations that were previously concerned about hefty tax bills from divestitures or asset sales may now be more willing to execute through alternative transactions. In addition, lower taxes should translate to higher free cashflows and rising enterprise valuations. This tailwind should support an active M&A environment with both buyers and sellers more willing to transact.

The lower tax rate may also impact private equity managers' decision on whether to operate portfolio investments as a corporate or partnership vehicle. In that regard, a number of publicly traded private equity funds are considering whether to convert to C corporation status to be more suitable for indexed mutual funds and exchange-traded funds. We have also heard that LP investors have taken a sudden interest in how tax reform will impact their investments, pushing funds to understand the ROI impact of tax reform.

Interest expense limitation

Private equity firms commonly utilise debt to finance buyouts and dividend recapitalisations. With the newly implemented cap on interest expense deductibility—30 percent of EBITDA for the next four years and 30 percent of EBIT thereafter—debt is now more expensive on an after-tax basis. Consequently, internal rates of return models may reflect lower valuations for highly levered investments. Furthermore, existing portfolio companies that are highly levered today would likely generate a lower return on investments, though the totality of the impact of tax reform needs to be considered; with the financing markets readily accessible at historically low rates, the impact may be somewhat mitigated. In addition, companies that underwent leveraged recaps or leveraged dividends in the past 36 months may want to consider refinancing or other capital structure alternatives to reduce the cashflow to interest expense that does not provide a tax shield.

Full expensing of capital expenditures

Under the new tax laws, the purchase of new or used fixed assets can be fully expensed in the year of purchase through 2022, with a four-year phase out after that. For companies that require high capital expenditures, the upfront deduction provides a benefit that may offset the effect of the incremental tax burden resulting from the interest deductibility cap. Private equity-backed companies in capital-intensive industries like construction and heavy manufacturing will likely explore accelerated capital investing activities to take advantage of these tax benefits. This may be particularly the case where the tax benefits of immediate expensing mitigate the interest expense limitation.

Potential winners and losers from tax reform

The big winners will include US-based telecom, transportation, retail, banks, healthcare, energy, real estate, and other stable, profitable businesses. Companies in these industries in the US typically have high effective tax rates, so the new 21 percent corporate tax rate should have a disproportionately large benefit to them. Stable businesses that can better manage the 30 percent of EBITDA limitation on interest expense deductions may be more favoured as M&A targets than cyclical businesses. Multinational companies that have substantial foreign activities may see less impact from tax reform, because their effective tax rates are already fairly low.

US technology manufacturers should see a substantial increase in cashflow from the reduced corporate tax rate as well as from the 100 percent expensing of capital expenditures, the repeal of the Alternative Minimum Tax, and the retained research and development tax credit. These companies may consider accelerating capex investments to maximise tax benefit.

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Healthcare M&A did not need a shot in the arm, as it has been very active throughout 2017— although we do anticipate an uptick in healthcare deals in 2018 based on the reduced corporate tax rate and 100 percent fixed asset expensing, which may drive up values based on increased cashflows. There are also some deals that were postponed in 2017 in order to see the outcome of, and potential value boost from, tax reform. This is particularly the case for healthcare services businesses, which benefit the most from the tax rate reduction. That being said, there may be a mild downturn in cross-border healthcare deals because tax rate arbitrage and inversions are no longer viable.

In addition to the substantial tax rate reduction, energy businesses will benefit from the 100 percent expensing of capex over the coming years, as well as from tax reform benefits targeting energy-focused companies. The result will increase both the net present value of these capital investments and cashflows. This is particularly the case for refiners.

Real estate investors who own through partnerships may see a decline in their tax burden as a result of the reduced tax rate for partners and favourable depreciation for real estate assets.

We are still considering the impact on targets with substantial net operating losses. While, historically, NOL companies provide extra value through the NOL shield, their value may decline because the value of the tax shield is reduced through the corporate tax rate reduction. That being said, there may be additional value for NOLs where the tax shield from interest expense is limited and pre-2018 NOLs, which are not subject to the 80 percent limitation. This may be especially the case where NOL companies can be utilised without the Section 382 limitation, which remains unchanged by tax reform. In addition, the new tax rules provide that the interest expense disallowed under the 30 percent of EBITDA limitation is deferred to future tax years and may become a valuable tax asset—but its use and value remain to be seen.

While some have speculated that the sweeping changes to the US tax on offshore earnings will trigger a strategic M&A boom—especially with the potential deluge of repatriation of offshore cash—we believe the response will be more muted. Many of the companies that have substantial cash offshore already have substantial cash in the US and have not gone on a buying spree. However, there may be opportunistic strategic acquisitions, especially where the 100 percent capex expensing can increase the ROI of the acquisition. Otherwise, these companies will likely engage in share buybacks, increased dividends, or refinancing of debt that would be subject to the 30 percent EBITDA limitation. Technology and pharmaceutical companies may revisit their IP strategies in light of the change in the U.S. tax system regarding offshore IP, though we do not anticipate substantial repatriation of IP to the US.

The tax law now requires a three-year holding period for carried interests to be taxed at the favourable capital gains rate, which remains at 20 percent. This may impact the holding period for some investments, though this requirement is much less dramatic than taxing them at the much higher ordinary income tax rate—especially given that the average holding period for an investment firm is greater than three years.

In conclusion, tax reform directly impacts many facets of the deal ecosphere. Dealmakers should expect to evaluate situations on a case-by-case basis, running the numbers to see if the benefits of the lower corporate tax rate and expensing of capex mitigate increased expenses from the interest expense cap. Though tax reform is estimated to cost about $1.5 trillion over 10 years, the economic theory is that tax reform measures will turbocharge the economy, increasing revenue growth sufficiently so the cuts will pay for themselves. Only time will tell the full impact of the reform measures, but, as is the case in any period of regulatory upheaval, those investors who are able to quickly adjust to the shifting tax landscape should be able to profit from plenty of attractive opportunities.

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