



Considering the impact of the tax cuts and jobs act on valuations

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On 20 December 2017, the House and the Senate passed the tax reform bill commonly referred to as the Tax Cuts and Jobs Act (the Act) and it was signed into law by the President on 22 December 2017. The sweeping modifications to the Internal Revenue Code include a much lower corporate tax rate, changes to credits and deductions for both businesses and individuals, and a move to a territorial system for corporations that have overseas earnings. The significant overhaul will have immediate and long-term implications on valuations of businesses, equity, and related assets and liabilities, as entities continue to assess the impact on corporate strategy, acquisitions, and financial and tax reporting.

We expect it will take buyers time to fully assess the impact of the Act. Investors appear to view the changes positively, and major stock exchanges have reached record high valuations in part due to the anticipated tax changes. Nevertheless, some market participants have taken a wait-and-see approach and have not incorporated the expected tax changes explicitly into their deal models. The longer-term impact on individual companies will likely take time to assess given the complexity of the Act, likelihood of future changes to the Act and potential adjustment to operating models implemented by management teams in response to the Act.

The basic approach to measuring value from a market participant perspective in an orderly transaction has not changed. Therefore, assessing the impact of the tax law change requires consideration of the factors that market participants would evaluate when transacting in an asset. It would not be appropriate to use a simplified approach by only changing the tax rate used and assuming that

other inputs remain constant. Similarly, it would not be appropriate to selectively include the impact of the Act on parts of the analysis, such as the after-tax cash flows, but not in others, such as the cost of capital. Due to the complexity of the changes, it is important to consider all of the implications when updating valuation analyses.

The effects of the Act when using various valuation approaches are discussed in further detail in the subsequent sections of this document. Ultimately, the many impacts of the Act on each company will continue to depend on individual facts and circumstances.

Valuation considerations

The valuation of a business, asset or liability is typically based either on an income approach, a market approach or a cost approach. The income approach focuses on the income-producing capability of the identified asset or business. The market approach measures value based on the price that other purchasers in the market have paid for assets or business interests that can be considered reasonably similar to those being valued. The cost approach is based on the premise that a prudent investor would pay no more for an asset than its replacement or reproduction cost. The Act may have a significant impact on the inputs used in analyses performed using the income or market approach.

1. Considerations of the impact of the Act on the income approach

The valuation of an asset using the Income approach is based on the income-producing capability of the asset and a risk-adjusted discount rate used to calculate the present



value of those future cash flows. For valuing a business, both elements are impacted by the corporate tax rate to varying degrees. Therefore, it is important to carefully analyze the impact of the tax rate in the analysis.

Cash flows

The Act changes not only the tax rate, but also the calculation of taxable income. For this reason, it will be important to carefully model and appropriately support the changes in taxable income due to the Act. Simply calculating a normalized tax rate on reported US GAAP earnings would most likely miss a number of additional impacts created by the Act. Key factors to consider include changes such as the treatment of capital expenses, limitations on the tax deductibility of interest expense and differences in amortization for US-based vs. foreign research and development costs. We expect valuation analysts to develop more complex models to derive the appropriate taxable income and related taxes to be paid accordingly. Similarly, since some of the provisions are to change over time or to expire altogether, a careful consideration of those assumptions in the future should be made and the reasoning appropriately supported and documented.

Discount rate

The discount rate applied to the expected cash flows to be generated by a business reflects the perceived risk of achieving those cash flows. It is generally calculated by weighting the after-tax cost of debt and the cost of equity by the proportions of each component in the actual or potential capital structure of the company.

The impact of a reduced tax rate on this calculated weighed average cost of capital (WACC) is complex, as it both affects the cost of equity and the cost of debt in different ways.

Calculating the impact on the after-tax cost of debt at first appears trivial, as a reduced tax rate increases the after-tax cost of debt. However, the calculation depends on the ability of business to deduct its interest expense, which will be limited by the Act.

Calculating the impact on the cost of equity is more challenging, as historical data used to estimate the market equity risk premium and the beta does not reflect the impact of the Act, and changes in the deductibility of interest expense would change the impact of leverage. Typically, the estimation of the beta, used to estimate the cost of equity

for a private company using the capital asset pricing model (CAPM), involves calculating an asset beta for publicly traded comparable companies using historical data, and re-levering by using the actual or potential capital structure of the company or industry and the tax rate to account for the tax shield afforded by the interest expenses. The tax changes would directly affect the beta through the changes to the interest expense deductibility and the tax rate used.

Finally, risks associated with the likelihood of achieving tax savings through the tax reform could also influence the WACC. Depending on facts and circumstances, the WACC using assumptions from the new Act could either increase or decrease compared to historic levels before the Act. The most important factor will be the company's leverage.

Terminal value

Some of the Act's tax cuts and provisions are temporary in nature with the intent to boost economic growth in the short to medium term. As a result, care should be taken when making assumptions to estimate the business value in perpetuity, both when using an income capitalization model (such as the Gordon growth model) or an exit multiple.

2. Considerations of the impact on the market approach

The valuation of a business using the market approach focuses on comparing the target to selected, reasonably similar (or guideline) publicly traded companies or prices paid in recent transactions that have occurred in the company's industry or related industries. Both the guideline public company and transaction multiples are affected by the corporate tax rate to varying degrees. For this reason, it is important to carefully analyze the impact of the tax rate on the analysis.

The observed increase in stock market valuations reflects the expected changes in tax rates, as well as companies' strong performance and growth expectations. Even though the tax rate for most companies is expected to drop, benefits and detriments of the tax reform to each company again depend on individual facts and circumstances. The tax rate cut, along with a shift to a lower rate on some foreign earnings, could help boost US-based corporate profits. Not surprisingly, the stock market has increased in part due to anticipation of these lower corporate taxes, which is reflected in the higher observed multiples. However, completed transactions may not have reflected the full

impact of the Act since they reflect pricing over a longer historical period, when the tax changes were uncertain.

When valuing a potential acquisition target, acquirers may reflect some of the aforementioned provisions in their deal models, but other acquirers have taken a wait-and-see approach. The limitations on the deductibility of interest expense, the impact of the lower tax rates on free cash flows, the net present value of the target's tax attributes and the form of acquisition (e.g., asset deal vs. stock deal) may all influence value. For example, as a result of full expensing of qualified capital expenditures, companies may need to consider their tax profile when deciding between a stock or asset acquisition. In certain cases, the ability to fully expense capital expenditures may allow acquirers to pay more for assets or businesses.

The market approach (guideline public company method) may incorporate market participants' expectations regarding value inclusive of the anticipated tax changes. However, care must be taken to select appropriate guideline public companies, especially when considering the valuation of multinational businesses or businesses with high leverage. Since some companies may benefit more than others, even within the same industry, these differences must be considered in the selection of multiples to apply in the valuation analysis. For that reason, we also expect valuation analysts to pay particular attention to forward-looking multiples, as the tax impact and growth will affect companies differently depending on their particular facts and circumstances.

3. Other adjustments

The Act includes other changes that may affect the value of cash or other assets on the balance sheet. Examples include changes to the treatment of net operating losses (NOLs) and deemed repatriation for overseas assets.

- **NOLs deduction.** Among the notable changes in the Act are two changes to NOL provisions. First, NOLs arising in tax years beginning after 31 December 2017 would be carried forward indefinitely but may not be carried back.

Second, the Act changes the amount of an NOL that a taxpayer may use to offset taxable income each year. The changes could affect the current value of NOLs.

- **Deemed repatriation liability for overseas assets.** The Act will shift the US to a territorial tax system, where foreign profits will be exempted from US tax. To transition to the new regime, the Act requires a deemed repatriation of existing overseas cash as well as for noncash assets. Companies will need to account for this tax liability.

4. Conclusion

The impact of the Act will vary by industry. Incorporating the changes into an analysis is more complex than solely reducing the income tax rate. Furthermore, there are significant changes to the treatment of interest

deductions and capital expenditures. Many of the changes will influence multinationals in complex ways and certain provisions of the Act may change over time or expire altogether. Incorporating the effects of the Act into each specific valuation will require significant analysis to fully understand the impact on the given company or asset.

Changes will also affect the cost of capital, and it may be difficult to measure how the market equity risk premium (cost of equity) will change. It is likely that market participants will regard the expected profits given the new tax rates as riskier or less certain, which may increase their required rate of return, partially offsetting the gains. It will be important to consider the impact of both factors so as to avoid overstating the benefit of the changes. Similarly, in the market approach, the observed increase in market multiples may reflect the expected changes in tax rates, but also reflects companies' strong performance and growth expectations. As always, it will be important to consider the specific facts and circumstances.



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