From Wall Street to Main Street:
Valuation Implications of Eliminating Interest Deductibility

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Discovering & Defining Financial Value

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What We Will Cover

1 Setting the Policy Stage

2 Corporate Interest Tax Deduction Research Study

3 What It All Means

1 Setting the Policy Stage

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ACG's Membership

ACG 2016 Public Policy Priorities

1. **Preserve Interest Deductibility on Corporate Debt**

2. **Reduce Onerous Compliance & Regulatory Burdens for Middle-Market Private Equity**

3. **Preserve the Current 'Joint Employer' Legal Standard for Middle-Market Businesses**

4. **Maintain Capital Gains Treatment for Carried Interest**

House Republican Tax Reform Blueprint

- **Titled "A Better Way Forward on Tax Reform"**
  - Released 6/24
  - Led by House Speaker Paul Ryan (R-WI) and Ways and Means Committee Chairman Kevin Brady (R-TX)
  - Blueprint proposes a move toward a cash-flow approach for business taxation and a consumption-based tax
  - Blueprint calls for 100% expensing of all capital expenditures and elimination of interest expense deductibility

House Republican Tax Reform Blueprint

- **What's Next?**
  - **House:** Blueprint is a messaging document – not the end but the beginning
  - **Senate:** Both Republican and Democratic senators have offered tax reform proposals that would eliminate or limit full deductibility of interest (i.e. Sens. Marco Rubio (R-FL) and Mike Lee (D-UT))
  - ACG is a member of the Businesses United for Interest and Loan Deductibility Coalition: "BUILD Coalition" www.BUILDCoalition.org
  - RGL Study and today's webinar all the more timely

2 | Corporate Interest Tax Deduction Research Study

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Summary of Findings

If the corporate interest tax (CIT) deduction were eliminated with no offsetting benefits:

- This would lead to a drop in equity value of 6.3% for middle market enterprises (MMEs).
  - Across all MMEs, this would translate into value destruction of **approximately <u>$1.1 trillion</u>**. *

- If even a 0.5% decrease in growth resulted, equity values for MMEs would decrease by 15.3%.
  - Across all MMEs, this would translate into value destruction of **approximately <u>$2.5 trillion</u>**. *

- The impacts were most notable for consumer discretionary, energy, healthcare, materials and telecommunication services companies but less emphatic for consumer staples, industrials and information technology companies.

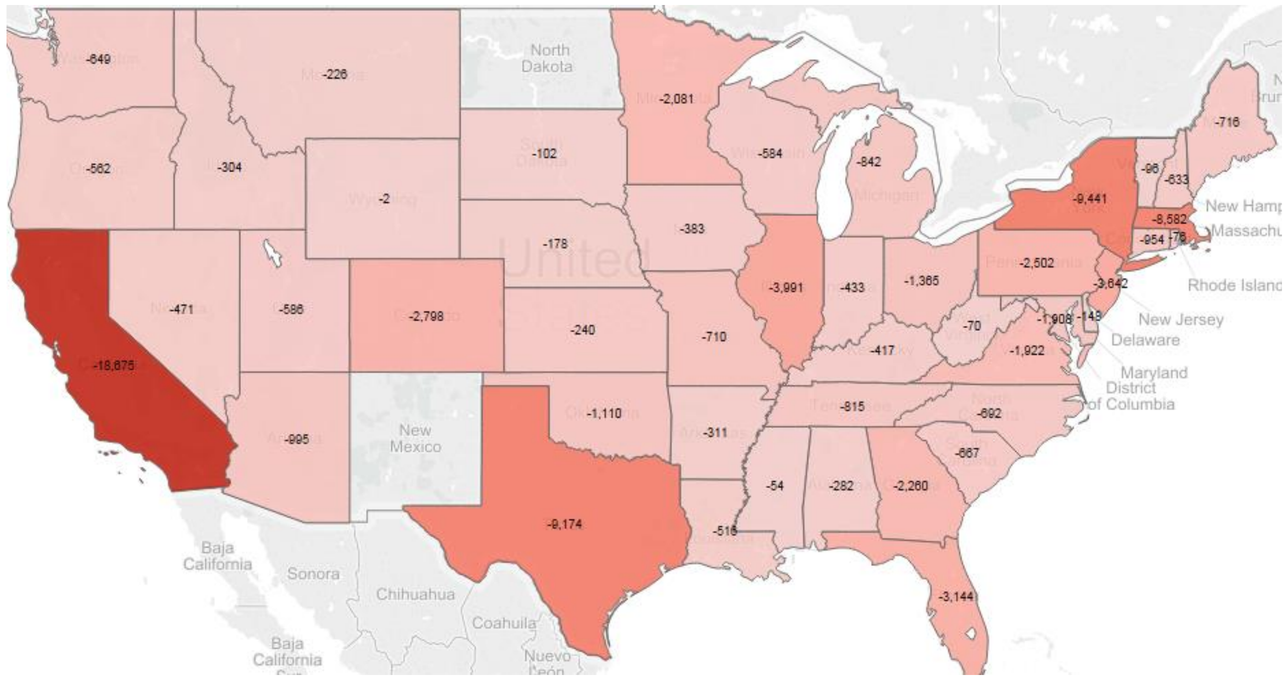
* Extrapolation based on the definition of MMEs by the National Center for the Middle Market.

Geographic Dispersion of Equity Losses

The equity value destruction across the sample of 835 companies is demonstrated at the state level in the figure at right.

Darker colors represent more damage than lighter colors.

Calibrated using a decline in the debt-to-capital ratio by as much as 10% and a 0.5% reduction in growth rate.



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Comments on the RGL Study

- The primary takeaways are:
  - Corporate valuation is dependent on not only income but also the cost of capital and growth.
  - Any discussion about eliminating or curtailing the CIT deduction must include an understanding that this long-standing feature of the tax code impacts all three variables.
  - As such, the bar should be set appropriately high in terms of devising a tax system that provides benefits to offset the negative impact that eliminating the CIT deduction would have on corporate valuations for the middle market.
  - “Revenue neutral” is not the same as “impact neutral” in terms of the equity valuations.

Access to Debt is Vitally Important to the Middle Market

- According to the U.S. Small Business Administration, approximately 80% of small businesses use some form of debt in their capital structure and 75% of startups use some form of debt financing at inception. (Cole, 2010)
- As Baker, Stein and Wurgler (2002) note, firms that depend only on equity to fund new investments will be less likely to proceed if it requires the issuance of undervalued shares.
- Even if one were to presume a reasonable valuation, the costs of raising equity to finance new projects is difficult because the market for non-controlling equity transactions is not well developed. (Berger and Udell, 1998)
- Moreover, these types of transactions carry significant costs as a percentage of the capital being raised.
- Due to their size, middle market enterprises tend to rely heavily on bank debt because they cannot effectively tap the corporate bond markets.

Traditional Arguments for Eliminating the CIT Deduction

There are two core arguments for curtailing or eliminating the CIT deduction, each of which is founded on debatable logic.

1. The <u>philosophical</u> argument is that the CIT deduction introduces asymmetry into the tax code because it causes interest to be viewed as an expense while dividends are viewed as a division of profits.
2. The more <u>practical</u> argument against the CIT deduction is that it encourages unhealthy levels of debt, which creates company-specific or even systemic risk.

How the CIT Deduction Affects Corporate Valuation

- Corporate value is expressed using a basic quantitative relationship:

$$\mathbf{CF \div (k - g)}$$

  - CF = after-tax cash flow
  - k = after-tax cost of capital
  - g = growth rate

- Corporate value is therefore a function of three factors: 1) cash flow, 2) risk and 3) growth
- Expanding the corporate value equation to demonstrate the tax impact:

$$\mathbf{k = WACC = Ke \times We + Kd\,(1 - t) \times Wd}$$

  - Ke = cost of equity
  - We = weight of equity in the capital structure
  - Kd (1 - t) = cost of debt less the tax deductible portion
  - Wd = weight of debt in the capital structure

Basic Mechanics of the RGL Study

- We begin with the quantitative relationship:

$$\text{(a)} \quad \text{Value} = \text{EBITDA} / (k - g)$$

- Using market data, we determined cost of capital for each company (k), which allows us to solve for the implied growth rate (g) for EBITDA embedded in companies' EBITDA valuation multiples:

$$\text{(b)} \quad g = k - (\text{EBITDA} / \text{Value})$$

- Having determined implied growth rates for the sample companies, the process of altering capital structures and growth rates for the sample to determine the impact of eliminating the CIT deduction is straightforward.
- Recalling that k is measured on an after-tax basis [$k \times (1 - t)$], eliminating the tax shield on interest expense produces an increase in k for companies with debt in their capital structure whose cost of debt (K_d) is lower than their cost of equity (K_e).
- Observed betas for sample companies were unlevered and relevered using the Hamada method.

Sample Screening Criteria

S&P's Capital IQ service was used as the platform for this study.

The seven screening criteria at right formed the basis for an initial sample of 1,142 publicly traded companies.

1. Traded on a U.S. exchange
2. Headquarters located in the U.S.
3. Operating as of December 31, 2014
4. Certain industry filters (discussed more on the next page)
5. Market capitalizations greater than $5 million
6. CY 2014 revenue between $10 million and $1 billion
7. CY 2014 EBITDA greater than $1 million

Industry Focus

Certain industries are more conducive to analysis of the type performed by RGL.

The industries at right were selected as part of the RGL study.

Banks & similar financial institutions, insurance underwriters, diversified financial companies and real estate companies were excluded due to the inability to distinguish between financial and operating liabilities.

The sample consisted of 835 MMEs* across a wide section of industries:

1. Consumer Discretionary
2. Consumer Staples
3. Energy
4. Healthcare
5. Information Technology
6. Industrials
7. Materials
8. Telecommunication Services

* 307 companies included in the above categories were excluded from consideration due to insufficient, unverifiable or unusable data.

Summary of Sample Findings

Assuming the elimination of the CIT deduction, the propensity to borrow will decline among MMEs. How much will be specific to each company's industry focus, needs and preferences.

With higher costs of capital, fewer growth projects will meet the necessary return characteristics to be funded.

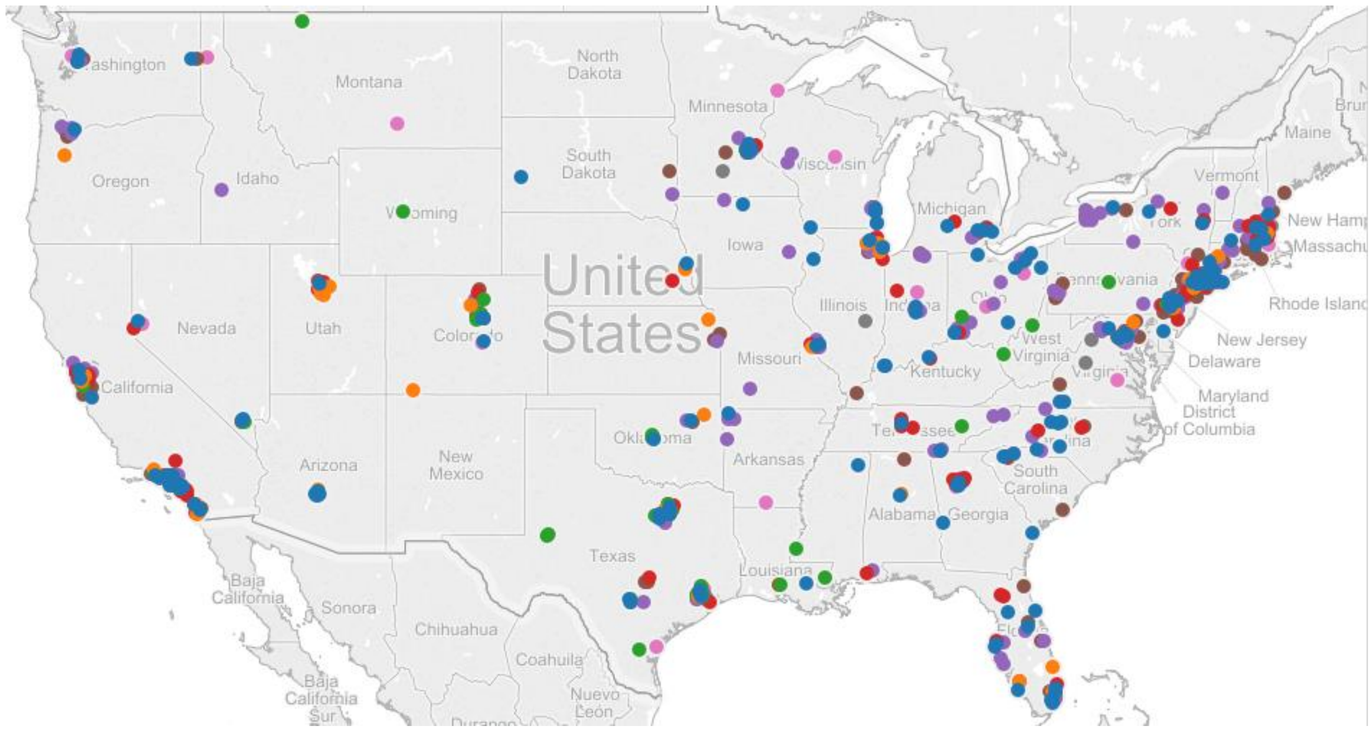
Summary statistics illustrate a decline in the debt-to-capital ratio by as much as 10% and a 0.5% reduction in growth rate.

Sector	Sample Count	$ Equity Change	% Equity Change
Consumer Discretionary	173	($14.1bn)	-16.2%
Consumer Staples	41	($2.5bn)	-12.6%
Energy	72	($6.7bn)	-16.2%
Healthcare	105	($17.0bn)	-17.5%
Industrials	164	($10.9bn)	-13.6%
Information Technology	216	($29.1bn)	-14.2%
Materials	46	($5.1bn)	-16.0%
Telecom Services	18	($2.3bn)	-21.8%
Totals	**835**	**($87.7bn)**	**-15.3%**

Geographic Dispersion of Sample

While generally scaled to population centers, the sample of 835 companies is significantly tilted toward the eastern half of the U.S.

The weighting to the eastern half of the U.S. is primarily a function of consumer discretionary and industrial companies in the sample.



Industry
- Consumer Discretionary
- Consumer Staples
- Energy
- Healthcare
- Industrials
- Information Technology
- Materials
- Telecom Services

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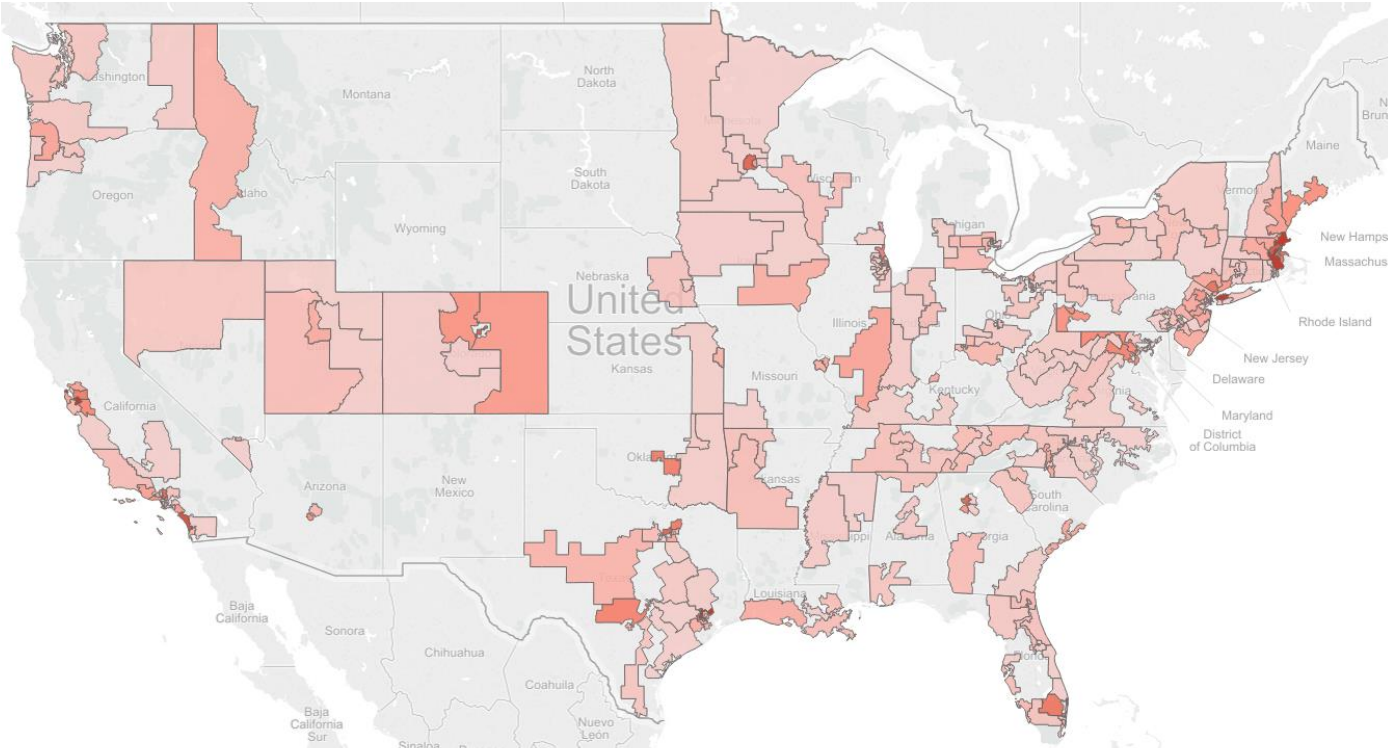
Geographic Dispersion by Congressional District

The equity value destruction across the sample of 835 companies is demonstrated at the congressional district level in the figure at right.

Darker colors represent more damage than lighter colors.

Calibrated using a decline in the debt-to-capital ratio by as much as 10% and a 0.5% reduction in growth rate.



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www.rgl.com/news-and-insights/CIT

3 What It All Means

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Life Cycle of Private Equity

INVESTORS /LIMITED PARTNERS, ex.

- Public & Private Pension Funds
  - Firemen & Police Officers
  - Teachers & Municipality Workers
- College Endowments
- Individuals /Family Offices

PRIVATE EQUITY FUND/GENERAL PARTNER

- Fundraises/Pools Capital
- Invests in Operating Companies
- Actively Manages Companies for Growth
- Life of Fund (7-10 years typically)

PORTFOLIO COMPANIES

- Operating Companies (i.e. manufacturing)
- Why? Seeking Partner for Growth, Retirement, Disagreement, etc.
- Goal is GROWTH

ASSUMING A SUCCESSFUL FUND. . .

- Capital is Returned to Investors
- Fees and Expenses Returned to Investors
- Gains are split 80/20
  - 80% to Limited Partner
  - 20% to General Partner

This information is presented for illustrative purposes only and is not intended to encompass all variations or styles of private equity funds/investing. Returns are not guaranteed and investments in private equity funds may result in a partial or total loss of invested capital.

Key Takeaways

- Tax reform is likely to be felt from Wall Street to Main Street, with the potential for significant implications for the middle market
- ACG is actively working in Washington to help inform and shape policy decisions that will affect the middle market – and not just the corporate interest tax deduction discussions
- Remember, the corporate interest tax deduction impacts corporate valuation beyond the amount of taxes paid, by increasing the cost of capital and decreasing growth

$$\textbf{Firm Value (V)} = \frac{\textbf{Cash Flow (CF)}}{\textbf{cost of capital (k) – growth rate (g)}}$$

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Matthew Morris is a Partner at the global forensic accounting and corporate finance firm of RGL Forensics. His practice focuses on the valuation of equity and debt securities and intangible assets for transactions, financial reporting, tax reporting and disputes, and commercial litigation. Concurrent with his role at RGL Forensics, he is Managing Director of RGL Advisors, the firm's broker-dealer unit. Matt is a veteran investment banker with 15 years of experience advising corporate clients and shareholders in transactions and has advised on more than two-dozen transactions with an aggregate value in excess of $2 billion. mmorris@rgl.com

Gretchen B. Perkins
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Gretchen Perkins has over 25 years' experience in the finance and business development sectors serving a variety of capital market participants. She is responsible for managing Huron's business development and investment sourcing activities, including outreach to deal professionals such as business brokers, investment banks, attorneys, accountants and consultants. Prior to joining Huron, Gretchen led the acquisition sourcing efforts at Long Point Capital, a middle market private equity fund. gperkins@huroncapital.com

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Amber Landis is the Vice President of Public Policy for ACG where she oversees ACG's day-to-day public policy program, advocating before Congress and the U.S. Securities & Exchange Commission. Amber also manages ACG's Private Equity Regulatory Task Force, a group of middle-market private equity chief compliance and financial officers who come together to address concerns about regulatory and compliance issues. Previously, Amber worked in the Washington, DC office of Fortune 200 manufacturer Whirlpool Corp., advocating before Congress on issues such as tax and international trade, and managing the company's political action committee and grassroots efforts. alandis@acg.org