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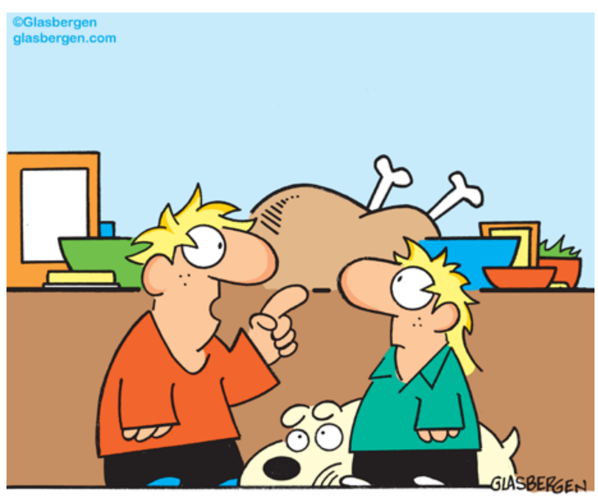
Fall 2018

Valuation and Tax Reform

If you value businesses for a living, chances are that you have attended at least one class, webcast or presentation that covers the Tax Cuts and Jobs Act ("TCJA") which was passed at the end of 2017. The TCJA made a number of changes to business taxes, which has an impact on how we value companies. At a high level, there are three primary changes (among others) that are likely to affect the value of businesses. They are described in the following paragraphs.

Lower tax rates should have a positive impact on the value of businesses. Nobody will argue over this point since valuation theory is based on after-tax cash flow. Things get interesting because C-corporation tax rates are now lower than pass-through entity tax rates (S-corporations and LLC's) which are lower than personal tax rates. As a result, some things we used to take for granted are now being looked at again as business owners work with their tax advisors to plan for the future. Some people predicted that a large number of S-corporations and LLC's would switch to C-corporations because of the lower tax rates. But that hasn't happened based on what I have seen. I think it is due to the fact that the double taxation of C-corporations remains, and there are some very good, non-tax reasons to set up a company as an LLC.



"On Thanksgiving the Four Basic Food Groups are 'more', 'a little more', 'a lot more' and 'too much'."

More generous depreciation rules should have a positive impact on the value of businesses, although the extra depreciation starts to phase-out in 2023. The new rules on depreciation will increase after-tax earnings for several years, which should increase the value of businesses in the near term. Interestingly, the new rules have more generous provisions to depreciate assets acquired in an acquisition. Many people thought that the new depreciation rules would not only improve the value of businesses, but would also encourage more acquisitions of smaller businesses (small businesses tend to be acquired in asset deals). While overall deal activity has held up in 2018, it doesn't look like the new depreciation rules are causing a large increase in M&A activity.

Limitations on the deductibility of interest expense should have a negative impact on the value of businesses, but in an indirect way. In valuation we generally don't count on an aggressive capital structure (meaning it includes a lot of debt) when valuing a business. But some private equity firms definitely use aggressive capital structures. The most aggressive users of debt have also tended to be the firms that have bid-up valuations the last several years. Limitations on their ability to deduct interest will change their return-on-investment outlook, which will likely cause them to bid at a lower valuation.

Corporate Value Partners, Inc.

Ronald D. DiMattia, President, 4545 Hinckley Industrial Parkway, Cleveland, OH 44109
(216) 741-1330 Office
ron@corporatevaluepartners.com • www.dealdesk.com

Corporate Value Partners, Inc.
4545 Hinckley Industrial Parkway
Cleveland, OH 44109-6009

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I wish you a safe and happy **Thanksgiving Day.**

The hard thing to tell is how long these tax changes will stay in place. This is important to consider from a valuation perspective, because valuation math generally assumes a perpetuity in the cash flow assumptions (meaning they remain in place for a very long time). If you think the TCJA changes will stay in place a long time, then there will likely be a fairly large improvement in the value of businesses. If you think they will not last too long, then the impact on value will be fairly minor. From my perspective, it seems that buyers of businesses are trying to figure out the likelihood that tax laws could change in the near future.

Complicating matters, interest rates are going higher, inflation seems to be firming and the international trade environment has gone through a number of changes. Therefore, it is hard to tell right now how much of an impact the TCJA is having on the value of businesses. It is arguable that the run-up in stock prices during part of 2017 and the first half of 2018 was fueled, at least in part, by the new tax law. But nobody really knows the extent of the impact. For right now we are where we have always been from a value-planning perspective: think things through, be cautious, and always keep in mind that the future will bring something unexpected.

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Please contact Ronald DiMattia at Corporate Value Partners at (216) 741-1330 or ron@corporatevaluepartners.com with any questions or if you need help with a valuation or corporate finance matter.

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