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2018 M&A Forecast in the "Corporate Friendly" Tax Era

By: Benjamin J. Michael   Date: January 29, 2018

Introduction

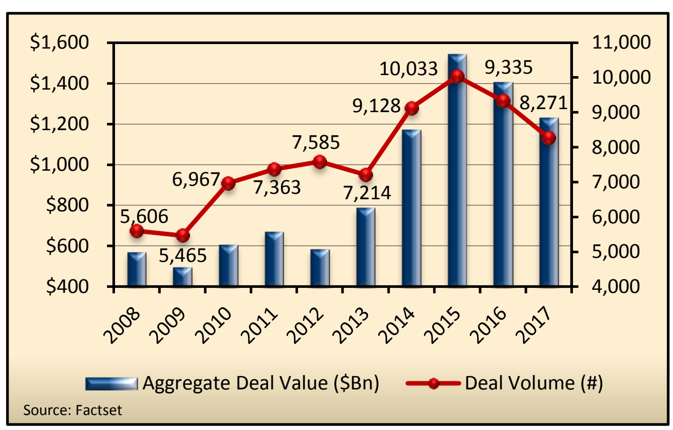
Headlines continue to be dominated by tax reform ever since President Trump signed into law the most comprehensive tax overhaul in three decades on December 22, 2017.[1] Companies near and far have emerged with positive news favoring the Trump Administration's first legislative victory in 2017. Before the ink was even dry, AT&T announced $1,000 bonuses for 200,000 U.S. based employees just in time for Christmas. Since then, as of January 23, 2018, over 169 public and private companies have announced positive news that will trickle-down to the lowest levels.[2] Bonuses, increased salaries and wages, and increased employer 401(K) match contributions are all on the table, which is good news for America's middle class.

Tax Cuts Extend Optimism Beyond Bonuses, Wage Increases

Tax reform impacts go much deeper than simply favoring America's workers. Recently, Apple Inc. announced that it will pay $38 billion as a one-time tax payment to repatriate some or all of its $252.3 billion of overseas cash – the largest of any U.S. corporation – all reportedly linked to the tax overhaul that reduces levies to 15.5% for American companies to bring foreign profits back home.[3] The Trump Administration believes that this policy will encourage companies to invest in domestic operations and infrastructure thus adding jobs, increasing salaries, profits and ultimately increasing tax revenue despite lower corporate rates (21% down from 35%). This is the "bigger-pie" theory combined with trickle-down economics that has become synonymous with GOP politics. If the public equity markets are any indicator, it seems to be working.

In addition to the one-time tax payment, Apple is also planning to invest $30 billion in the U.S. over a five year period which includes a second headquarters.[4] All of this information comes as Amazon released its short list of cities for their second headquarters. Bezos and his executive team hope to finalize the location this year.[5]

Annual M&A Activity



The Real IB Question

The real question from investment bankers is whether the new tax policies will affect their ability to win and close deals, which isn't possible if companies aren't in the deal-making mood. Answer: Indirectly yes, with a caveat or two. Let's examine.

What Happened to 2017?

To understand the go-forward 2018 M&A environment and especially how the new tax law will affect M&A, it's first necessary to understand the current situation. 2017 proved to be a lackluster year for M&A advisors despite optimism in Q4-2016 and Q1-2017. Deal counts declined. IPOs and "mega-deals" seemed nonexistent for most of the year, which perplexed many experts who were optimistic from the GOP Hail-Mary victory. Of course there were a few deals to be had (i.e., the SNAP IPO in January, Krispy Kreme owner JAB acquired Panera Bread in April, Amazon entered the grocery space in a surprising acquisition of Whole Foods in June and the year wrapped with the largest acquisition of the year – $69 billion – CVS acquiring Aetna).[6] But the year's biggest stories had nothing to do with M&A and instead centered on the 25% increase in the DJIA[7], three FOMC interest rate hikes, WTI recovery and emergence of cryptocurrencies as dinner-table conversation, thus spawning a new acronym: "ICO" or Initial Coin Offering. So what happened to the forecasted M&A surge?

There are many reasons the 2017 M&A forecast didn't come to fruition. First, despite the unexpected zeal from the Trump victory, dealmakers and executives were still skeptical about Trump's ability to implement his plan and rally a divided GOP behind him. Legislative reforms including tax, healthcare, and immigration all fueled uncertainty. Executives tend to adopt a "wait and see" principle when uncertainty rules. Second, the lack of IPOs is most likely linked to the availability of large amounts of private capital. Mega-funds willing to cut big checks, combined with relatively cheap, available debt capital resulted in executives opting out of the risks and costs associated with an IPO. Why wager on the public markets and tap-dance to satisfy demanding shareholders when private equity is plentiful? Third, valuations and multiples that buyers are willing to pay have remained high because of fierce competition for the few "good deals" available. Capital raised by PE funds is at an all-time high and competition from well managed and capitalized strategics is steady. We all know what happens to prices when supply is reduced and demand is increased. Financial buyers' appetite to pay inflated valuations didn't overcome their need to deploy capital, resulting in fewer deals in 2017.

Where does that leave us for 2018?

It's our opinion that the M&A landscape is on an upward trajectory with one of the prime catalysts being tax reform. Since the amended tax bill passed the House and the Senate and was later signed in Q4, the M&A space has gained momentum. CVS announced their mega-acquisition and tech-leaders Spotify[8] and Dropbox[9] have filed confidential IPO listing documents with the SEC. Survey Monkey CEO Zander Lurie has indicated that the 19 year old company is likely to go public in 2018.[10] Other tech companies on the IPO short list are Lyft, Airbnb, and Pinterest, to name a few.[11] If Uber can sort out their internal issues, we might see them on the list as well. Just today, the year's first mega-deal was announced that JAB backed Keurig Green Mountain will acquire Dr. Pepper Snapple to form a hot and cold beverage conglomerate that will be called Keurig Dr. Pepper and trade on the NYSE. Dr. Pepper Snapple shareholders will receive $19 billion in cash and a 13% equity stake in the new entity.[12] Dell is also on the move. They are considering a reverse merger with VMware, an entity in which they acquired an 80% stake as part of the 2015 mega-deal acquisition of EMG for $67 billion. Dell is also considering other financial strategies such as an IPO, acquiring the remaining 20% of VMware or other acquisitions.[13] Let the games begin (not just the Olympics).

M&A Specifics of Tax Reform

Corporations will see higher net incomes due to their 14% tax savings. Additionally, President Trump has laid the groundwork through tax reform for companies to repatriate overseas cash and simultaneously make America more competitive in the international market for business owners to set up shop; previously America had one of the highest corporate tax rates in the world. With all of this extra capital, executives have been scrambling to update their business strategies. Companies will begin to increase dividends to shareholders and begin stock repurchase campaigns with their extra cash; investments in capital equipment, human capital, infrastructure, and organic growth will also increase. All of this activity will drive increased EBITDA resulting in higher valuations and eventually increased multiples.

CEOs from coast to coast have indicated that acquisitions will be high-priority for future growth plans. Tax reform has also made it beneficial for companies to sell-off non-performing business units. In prior years companies would be taxed at the 35% rate upon a divestiture, which encouraged spin-outs instead of an out-right sale (i.e., Yahoo's Asia assets, HP's split into two companies in 2015 and GE's spinoff of credit card issuer Synchrony Financial in 2014).[14] Hypothesis: We will see increased activity across the board from the middle market to giants breaking up and selling off … GE, anyone?

For more details on corporate tax reform see Appendix A, Table 1.

When the Big Dogs are Hungry … Feed Them

With all of the activity and buzz surrounding public company acquisitions, one can't help but ask, "Will this extend into the middle market?" We believe so, and for the following reasons: middle market deal flow was down in 2017 by only 11%. This trend will reverse as hungry strategic acquirers, armed with cash, are ready to act. Secondly, the one uncertainty in the market right now is timing of the next correction. Everyone is optimistic, as it seems the markets can do no wrong. But a correction is coming; it's economics 101. The million dollar question is when? However, there has to be a catalyst of some sort, but the equity markets seem to be callous towards any negative news. Furthermore, there are no obvious indicators (other than the yield curve) or conspicuous events that could derail the locomotive. This is just all the more reason that deal flow will surge. Folks standing by will decide to act and begin the sales process, which can be a five to nine month evolution. At the very least one should begin to prepare their company for a sale by seeking advice from an M&A advisor which most firms, like Commerce Street Capital, will provide for free. It can take 18 months for a business owner to properly prepare their books, projections and operations for a potential sale.

Conclusion

The market is ripe, a correction is in the telescope, multiples are high, strategics are active, debt financing is still cheap, equity financing is plentiful and all indicators are that now is the perfect time. The last thing any middle market stakeholder wants is to miss the wave by selling when multiples are 5x instead of 10x. It all goes back to the basics: buy low / sell high; the M&A market is high and now is a great time to seek M&A expertise.

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Appendix A, Table 1:

2018 Tax Reform Summary[15,16 & 17]

Policy	Corporate Tax Law		Effect on:		
	Previous	New	Industry	M&A	Private Equity
Top corporate tax rate	35%	21%	Positive	Positive	Neutral
Business interest deduction	Generally fully deductible	Caps deduction at 30% of income	Negative	Neutral	Negative
New investment purchases	Complex rules for deduction over many years	Five years of full expensing, then phased out over five	Positive	Neutral	Neutral
Section 179 expensing of capital expenditures	Small business expensing limited to $500,000	Increases limit to $1MM	Positive	Neutral	Positive
Tax deduction on pass through entities (i.e., S-Corp, LLC, LP)	N/a	20% deduction	Positive	Positive	Positive
Carried interest from investments	If held < 1 year, pay capital gains tax	If held < 3 years, pay capital gains tax	Neutral	Neutral	Negative
Repatriation of overseas profits	N/a	15.5% Cash & Equivalents 8% Illiquid Assets	Positive	Positive	Neutral
Net Operating Loss (NOL)	Can deduct NOL from income in other years	Limits the deduction to 80% of taxable income	Negative	Neutral	Negative
Corporate alternative minimum tax	Alternative income tax calculation for businesses	Eliminated	Positive	Positive	Positive

Endnotes:

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