# HERE'S HOW TAX REFORM WILL SHAPE THE PRIVATE MARKETS

*By Brian Gildea, Managing Director*

The year 2017 has come and gone, and tax reform – by the name of the Tax Cuts and Jobs Act (TCJA) – has (finally) passed. As with any sweeping legislative overhaul, there has been no shortage of speculation regarding how the plan will ultimately impact various parts of the financial and economic landscape. Rarely the wallflower, we thought we'd join the debate and address what the TCJA means for private markets portfolios.

Let's start with the macro. The U.S. public markets have reacted positively in anticipation of and since the passing of the tax reform bill. This reaction is based on the belief that the tax reform will increase corporate earnings and cash flow immediately. Longer term, the consensus view is that tax changes will improve the relative competitiveness of U.S. companies, and potentially spur higher GDP growth (a point that economists debate heavily). Second-order effects, such as how this will impact interest rates, remain largely unknown, and I won't speculate about those here.

What does this mean for the private markets? Overall, tax reform should be a win for the asset class. U.S.-domiciled companies represent the majority of private markets portfolios. We expect earnings and cash flow to increase beginning in 2018, since the changes are effective as of January 1 this year. A JP Morgan report analyzing the S&P 500 estimates earnings will increase by an additional 5%-8% in 2018 due to tax reform alone. PE portfolios are made up of smaller companies than the S&P, and are generally regional or domestic in nature, so they should have an even better experience. Exactly how much better? You'll have to keep reading.

### Impact on Deal Returns

As in the public markets, there will be winners and losers at the individual company level. The biggest winners on a relative basis should be U.S. companies, with 100% domestic revenue, high current tax rates, average-to-low debt levels and high capital spending. Counted among the losers will be unprofitable companies and highly levered businesses that will lose some of the ability to deduct interest expense. On that point, analysis by our Research Team suggests that the tax reform is a net positive for investment returns – that is, until leverage levels and/or cost of debt exceed normal market levels. Depending on the company-specific characteristics, deal returns should improve by anywhere from 30 to 170 basis points under the new tax law, assuming other key factors are held constant (more on this in a minute)

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## Impact of Tax Cut & Jobs Act of 2017 on PE Deals: IRR

| | Lower Corporate Tax Rate | Cap on Interest Expense Deduction | Expense Cap Ex | Indicative Net Result |
|---|---|---|---|---|
| High Debt/EBITDA or High Cost of Debt | 80-100 bps | (100-120) bps | 20-30 bps | 30-50 bps |
| Low Debt/EBITDA or Low Cost of Debt | 130-160 bps | 0 bps | 20-30 bps | 140-170 bps |
| High CapEx | ~130 bps | ~(40) bps | ~80 bps | ~140 bps |

- Several items in the tax reform bill will significantly impact the profitability and cash flow of private deals. Some will lower the tax bill while others might raise it. For domestically focused U.S. companies we expect the overall impact to be positive, but much depends on the level of debt relative to profitability and the capital intensity of the business.
- Overall, we expect that the improvements in the tax rate and expensing capital goods to more than outweigh the cost of limiting interest deductibility. The largest gains accrue to those companies with little interest expense relative to EBIT and those with high current capital spending.
- One area of concern would be companies with high interest expense to EBITDA. These companies may already be experience stress, and with the tax reform they would lose some interest deduction. The associated negative cash flow impact only worsens their stress.

Source: Hamilton Lane Data

In our analysis, the drag from the limited interest deductibility does begin to offset some of the benefit of the tax cut once debt levels approach 5x leverage. You can see this in the chart above as the large, red arrow which is reducing the returns for High Debt/EBITDA or High Cost of Debt investments. As this leverage effectively becomes more expensive due to the lost tax deduction, GPs will rethink optimal capital structures for each business.

Now, back to the earlier point, in case you missed it: holding everything else constant, our analysis shows that new deal returns are 30-170 bps better! That doesn't mean, however, that LPs should assume that from this date forward returns will improve by that amount. We have always maintained that GP behavior for new deals adjusts quickly, and, in fact, we'd note that is happening already.

For new deals, GPs are pricing in the impact of tax reform--rather than targeting higher IRRs for new deals, they are willing to pay more for assets to achieve the same returns they were targeting before. The bad news for LPs is that prospective deal returns aren't any better off than they were before, but the good news is that existing deals and portfolios should benefit from higher valuations immediately.

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How much will existing assets benefit from higher valuations? Our research suggests that GPs will be willing to pay anywhere from 0.1x to 0.75x higher multiple of EBITDA, which translates into an increase in equity values of 3%-17% for existing assets. We expect a portion of this appreciation to occur immediately, while some of it will be reflected over the coming quarters as the benefits are fully quantified and captured in the cash flow on an asset-by-asset basis.

### Impact on Equity Value of Deals

| | Lower Corporate Tax Rate | Cap on Interest Expense Deduction | Expense Cap Ex | Indicative Net Result |
|---|---|---|---|---|
| High Debt/EBITDA or High Cost of Debt | 8-10% | (9-11%) | 2-3% | 3-5% |
| Low Debt/EBITDA or Low Cost of Debt | 12-15% | 0% | 2-3% | 13-17% |
| High CapEx | ~12% | ~(4%) | ~7% | ~13% |

- The analysis on the previous page assumes that GPs will not change their underwriting in a new tax environment. That seems unlikely. Instead, we assume that GPs will underwrite to the same returns and that purchase prices will increase across the industry.
- This implies that equity in all currently held companies will receive a one-time value adjustment, as the leverage on companies remains the same but the enterprise value increases due to the rise in EBITDA multiples.
- The tax bill should be a net positive on the equity value of currently held companies, though companies with over 7.5x leverage or with a weighted average cost of debt above 11% could see their equity value fall.

Source: Hamilton Lane Data

### Other Implications

What else? No doubt, GPs are preparing new fund PPMs as you read this, or at least updating their materials to state the intention to target businesses with the characteristics we described. Secondary players are likely targeting portfolios heavy on those types of assets, hoping to buy them before their valuations tick up. Thoughtful, diligent managers will be able to add some amount of return through this arbitrage.

Much of this analysis is focused on the buyouts segment of the market, as it is the area we believe will be most impacted by the change in corporate tax rates. Venture will be less impacted, since most companies are not current tax payers.

### Credit

For credit investors, one of the key questions to ask is, “What are the implications on borrowers’ ability to repay loans?” Thanks

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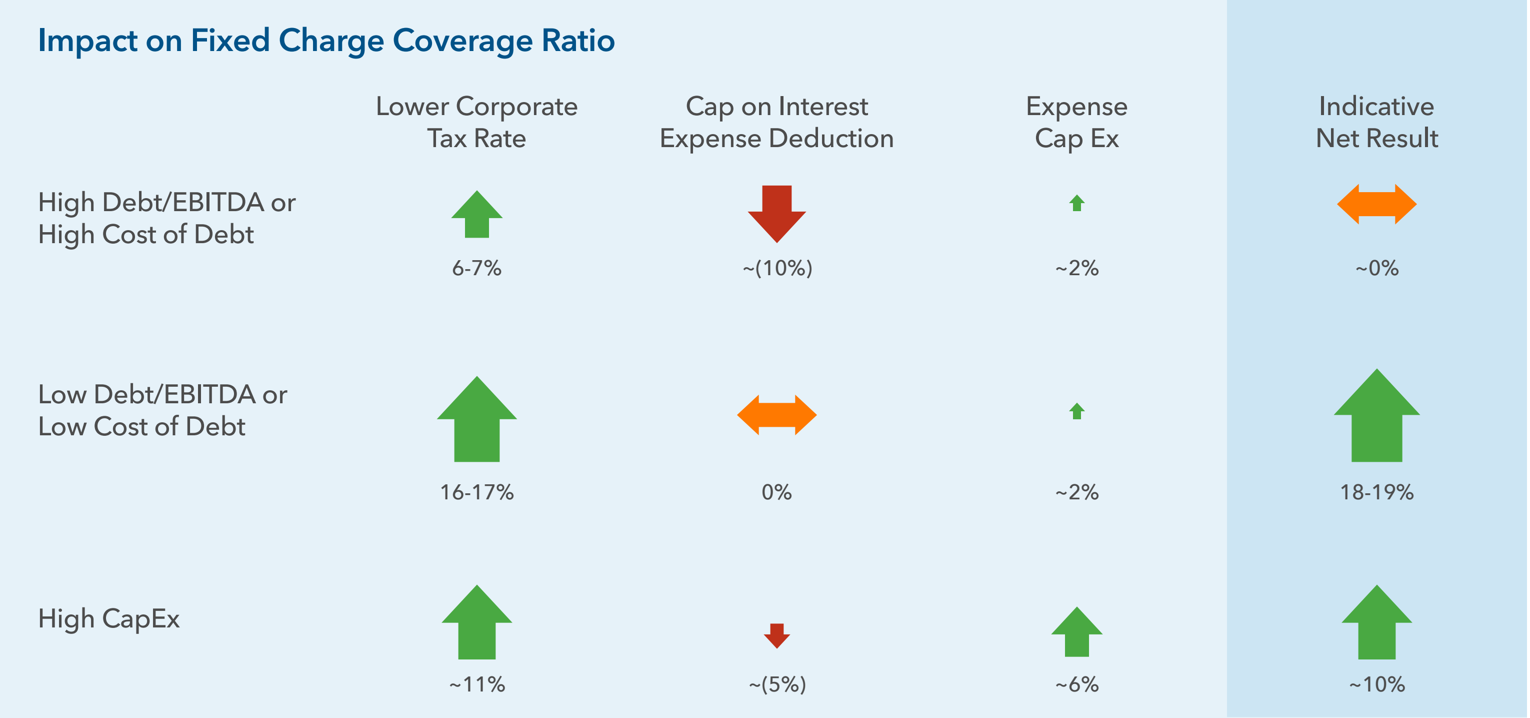
again to our Research Team, we are able to quantify the impact on company-level cash flow, as measured by a fixed-charge ratio, and our analysis shows the answer is a good one for credit investors. Overall, fixed-charge ratios should at worst be equal to current levels, and at best improve by up to 19%.




- From a credit investor's standpoint, the tax bill should increase the levered free cash flow available to many companies to service debt. The chart above shows the expected change in the Fixed Charge Coverage Ratio in a company's first year under the new tax bill.
- Companies with high debt could become more risky in the near term for credit investors, as the cap on deducting interest expense will significantly decrease levered free cash flow. However, this should improve in future years as debt is paid down over time and excess interest expense is carried forward to future years.

Source: Hamilton Lane Data

There are, however, some larger questions that we will see play out over time. With the cost of debt becoming higher due to both rising rates and lower deductibility, what will that mean for debt issuance overall and, more specifically, at the junior end of the credit spectrum?

I have wondered whether one of the more interesting elements to play out could be wrangling over the definition of adjusted taxable income. Tax experts that I have spoken with believe that the terms are clearly defined, but that doesn't mean there won't be interpretation. Yes, we know that interest deductibility will be limited to 30% of a metric similar to EBITDA through 2021, but is that metric fully defined? As you probably know, adjusted EBITDA, pro forma EBITDA and even run rate EBITDA have become common terms in recent years, yet the definitions vary company by company. With a clearer classification of what the IRS counts as EBITDA, I wonder whether companies will be able to push the definition as aggressively with lenders as they have in the recent past.

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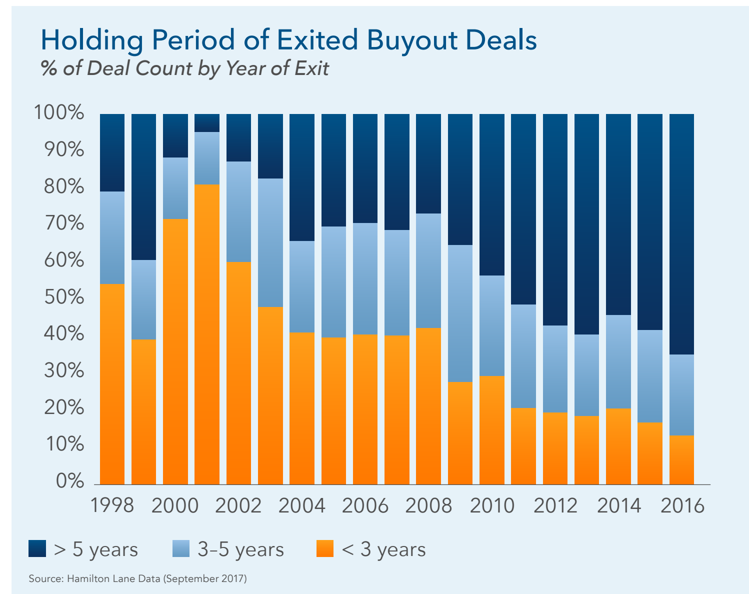
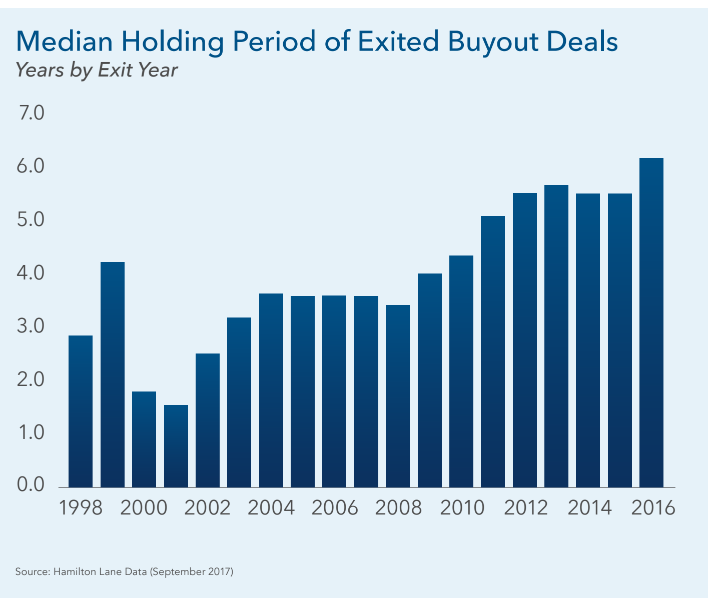
## Carried Interest

Surprised that you have made it this far without reading about carried interest? Readers may recall that last spring we predicted that any tax reform would not result in treating carried interest as ordinary income. It turns out we got that prediction 87% correct, and this is a big win for GPs. As for the provision that deals held less than three years will be taxed at current income rates? It's a snoozer - it just won't have any significant impact. We have been talking for years about assets being held longer than ever before (an average of six years), with fewer quick exits. In 2016, only 13% of deals exited were held for less than three years (hence our 87% success rate) as shown in the chart below.




On the margin, for those rare early exits, will a GP target a sale process for a date that is two months later than they would have otherwise? Sure, but our perspective is that this will occur infrequently and the impact will be marginal.

## Other items of note

Non-U.S. investors and tax-exempt investors that invest through blocker structures will benefit from the reduction in corporate taxes from 35% to 21%. This change should improve returns, making the private markets relatively more attractive to these types of investors. However, there will be less of an impact on non-U.S. investors in real estate and real assets, as the Foreign Investment in Real Property Tax Act was not modified by the latest tax reform and still imposes additional tax burdens on foreign investors in real property, including corporations with income primarily driven by real property investments.

Another element of the new tax law that will impact the asset class is the 20% deduction with respect to pass-through business income. Some segment of deals are able to be structured as pass-through entities (e.g. partnerships, S corporations), and these types of businesses will be more valuable to owners and buyers. Real estate is likely to benefit moderately from this change as many real estate assets are held through partnerships and S corporations.

Expect to see changes in the way that funds and deals are structured as GPs create customized structures that work best for their investor base and deal types. Within deals, we will see corporate structures evolve to maximize the impact of favorable tax provisions while minimizing the impact of the less favorable. The parallel here would be the recent history of corporations borrowing at foreign subsidiaries, or owning intellectual property in separate entities.

As those of you who read our latest Market Overview know, the use of fund-level capital call facilities has been a hot topic in the private markets of late, and we don't expect the usage of credit lines to be impacted given the limited amount of interest expense relative to portfolio income. Even for levered funds (e.g. senior credit funds using 2:1 leverage), there should be no impact due to the way the code is written.

## Final thoughts

While there are lot of elements to weigh and consider here, our view is that this is a clear net positive for the asset class. With U.S.-domiciled companies comprising the majority of private markets portfolios, an expected uptick in earnings and cash flow and minimal impact from a carried interest perspective, the private markets as an asset class should come to represent one of the winners from the passing of this historic tax reform.

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