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The Tax Bill and You

Implications for the Investment Management Community

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Topic Outline

Outline broad changes in the tax code

Major issues for the market, investors, and owners

Implications for market multiples and RIA valuations

Impact on AUM, revenue, and profitability

Comparing the effect on C Corps versus S Corps

Follow up issues and next steps for RIAs

Introduction to the Tax Bill

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Tax Bill Introduction

The Tax Cuts and Jobs Act (TCJA) was signed into law on December 22, 2017

Among other things, the tax bill reduces the tax rate on "C" corporations from 35% to 21%

For RIAs, advisor fees are no longer a line-item deduction for clients

Many S corps and LLCs can deduct 20% of Qualified Business Income (QBI), but investment management firms above a certain income threshold cannot deduct QBI

Tax efficient structure of S Corps relative to C Corps is muted

TCJA Implications for Clients

Some things left unchanged

- Long term capital gain and qualified dividend tax rates unchanged
- 3.8% net investment income tax also retained for households earning over $250,000 and municipal bond interest payments remain tax free

Lower rates may spur more investing

- Lower income tax rates (corporate and personal) suggest more after-tax income available for investment
- Lower personal rates reduces pre-tax spending levels for retirees and trust beneficiaries

Market appreciation suggests potentially lower prospective returns on equities unless higher after-tax cash flow justifies multiple expansion or earnings growth increases

- If prospective returns are weaker, alternative and international asset classes start looking more attractive

TCJA Implications for RIA Owners

Tax bill bullish for AUM

- AUM up with market conditions for equity managers
- Investors will have more after-tax dollars to invest

Tax bill improves firm economics

- Revenues rising with AUM assuming no fee contraction
- Rising revenue and fixed costs mean significant gains in profitability for most RIAs

Tax bill improves firm valuations

- Higher after-tax cash flow improves valuations
- Income models suggest pre-tax multiples should expand
- Market valuations for RIAs have increased

Tax Bill Impact on the Market

The Market is Higher, but Why?

Since the election…

The S&P 500 is up 26%

The Nasdaq is up 36%

The Russell 2000 is up 26%

If value is a function of cash flow, risk, and growth, which factor accounts for recent market activity?

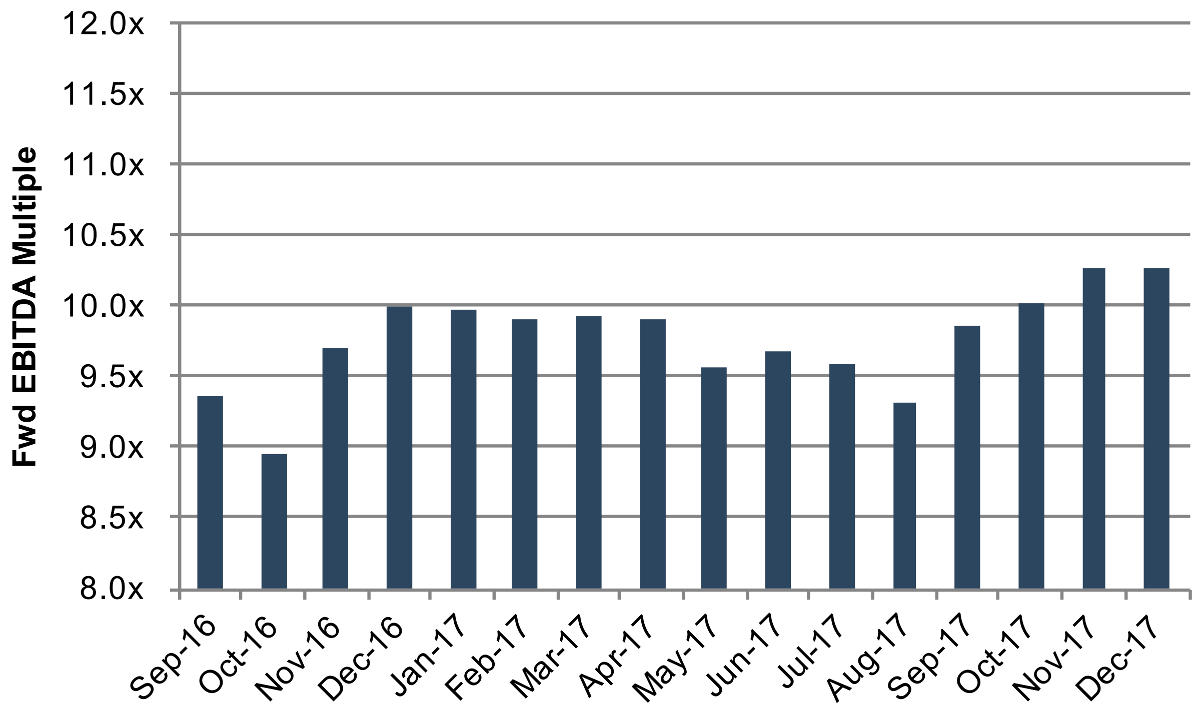
V = CF / (R – G)

Valuation Multiples Have Drifted Higher

S&P 1000, ex FIRE

Forward EBITDA multiples for the S&P 1000 (x FIRE) were ~9.0x to 9.5x when it appeared Clinton would be elected

Coincident with the prospect of tax reform, multiples gapped up about a full turn to ~10.3x toward YE 2017

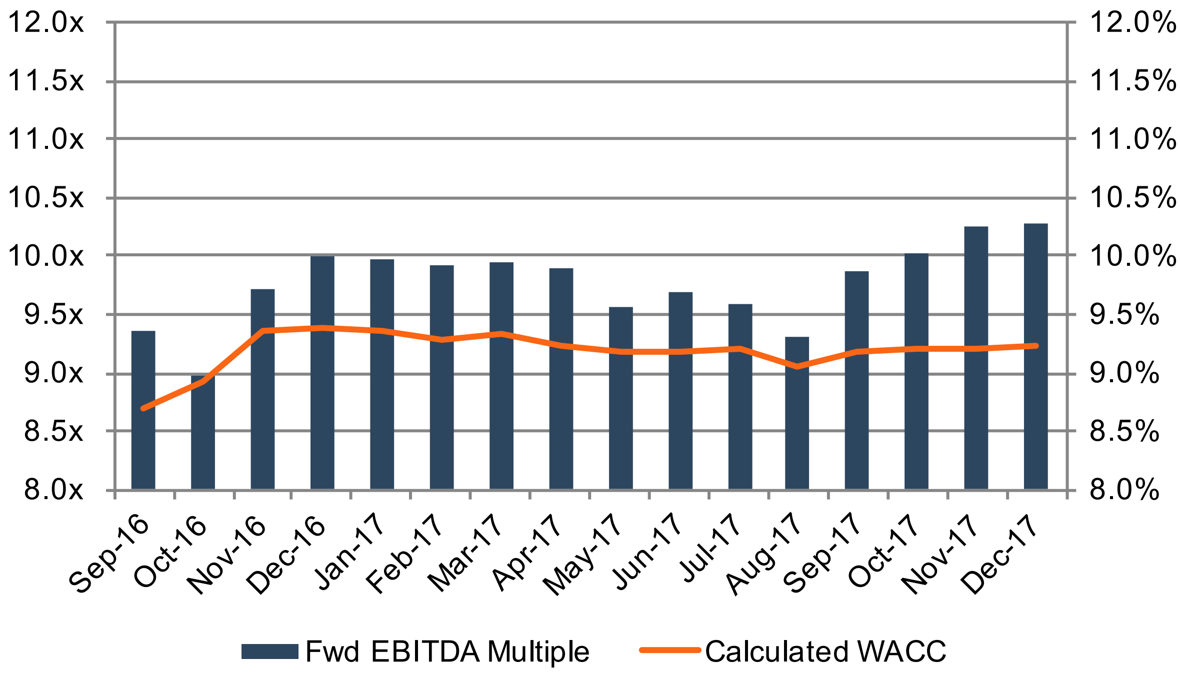


…while WACCs Have Followed Rates

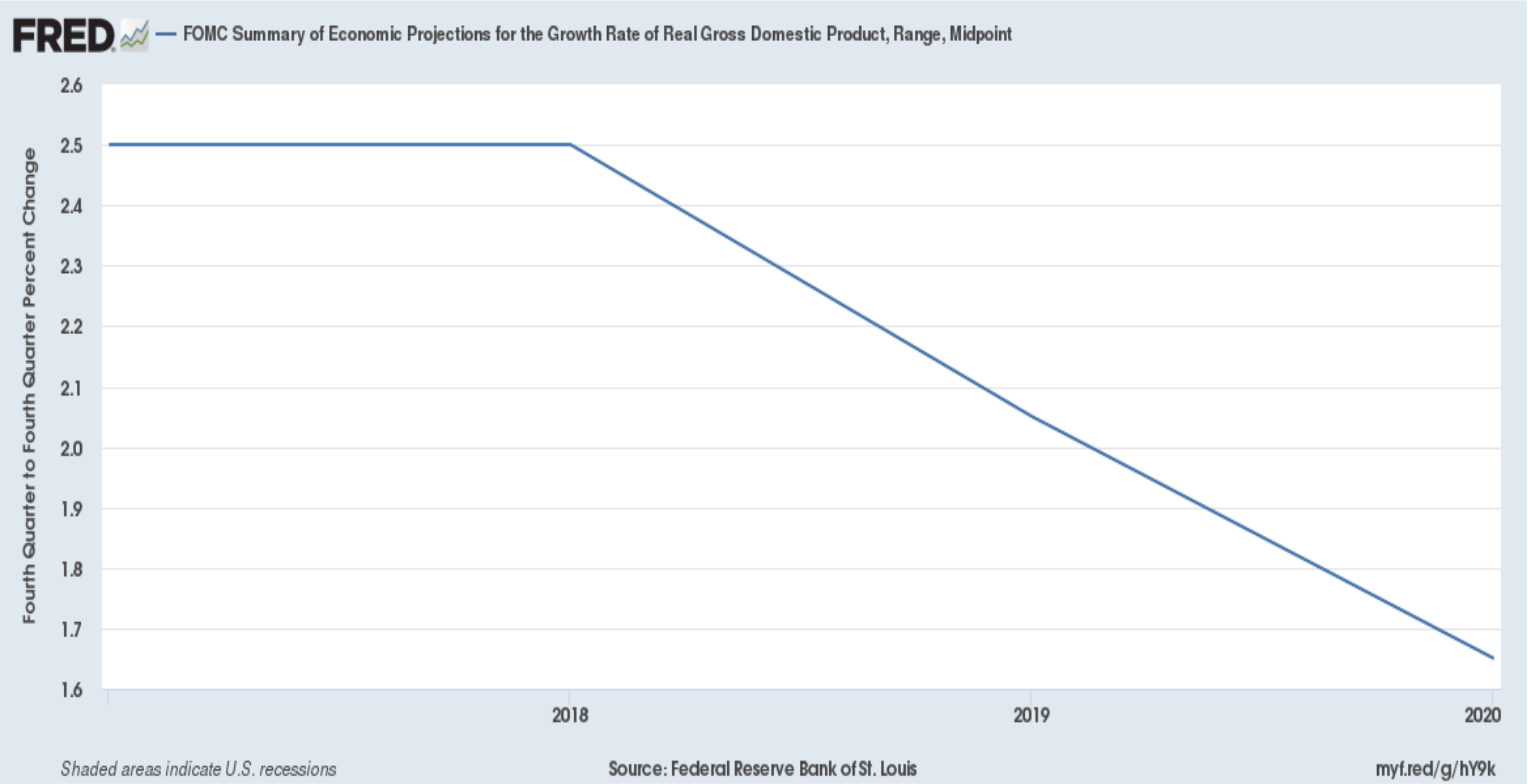
Multiple expansion has not followed the cost of capital

We can interpolate a WACC for the selected index of about 8.5% in September 2016, when long dated treasuries yielded ~2.0%

The risk-free rate gapped up to ~2.8% in December of that year, pushing the implied supply side cost of capital up to about 9.2%



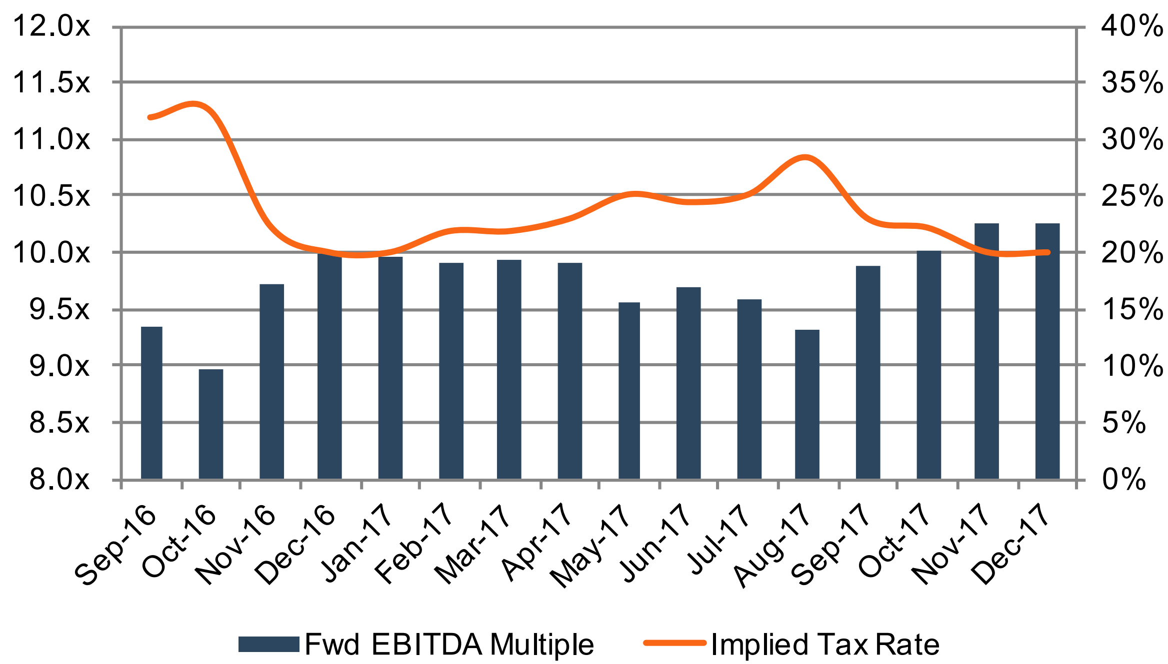
And Expected Growth Hasn't Really Changed…



So the Difference is NOPAT

No surprise: lower tax rates make EBITDA worth more

Using a DCF model framework to evaluate the impact of a change in tax expectations on valuation multiples, we can let the cost of capital float with interest rates and hold growth expectations constant, such that the change in valuation multiples can be attributed to the change in tax rates



Implication for RIA Economics

RIA Revenue Grows with the Market

Market appreciation is driving ongoing management fees higher

	Before Tax Bill	After Tax Bill	*% change*
Equity AUM	$4,000,000	$4,400,000	*10.0%*
Debt AUM	1,000,000	1,000,000	*0.0%*
Total AUM	$5,000,000	$5,400,000	*8.0%*
Equity mgmt fee (bps)	65	65	*0.0%*
Debt mgmt fee (bps)	20	20	*0.0%*
Implied Total Revenue	$28,000	$30,600	*9.3%*

Consider a $5B AUM firm that yields 65 bps from $4B in managed equities and 20 bps from $1B in fixed income

After the 10% increase in equity AUM from the TCJA, revenue grows 9.3%

*Assumes no change in debt portfolios, fee breakpoints, or rebalancing

RIA Profitability Increases Because of Operating Leverage

Operating leverage exacerbates impact of market activity

	Before Tax Bill	After Tax Bill	*% change*
Equity AUM	$4,000,000	$4,400,000	*10.0%*
Debt AUM	1,000,000	1,000,000	*0.0%*
Total AUM	$5,000,000	$5,400,000	*8.0%*
Equity mgmt fee (bps)	65	65	*0.0%*
Debt mgmt fee (bps)	20	20	*0.0%*
Implied Total Revenue	$28,000	$30,600	*9.3%*
G&A	$4,200	$4,200	*0.0%*
Salaries	9,800	9,800	*0.0%*
Bonus Comp	4,200	4,980	*18.6%*
Total Expense	$18,200	$18,980	*4.3%*
EBITDA	$9,800	$11,620	*18.6%*
EBITDA margin	*35.0%*	*38.0%*	

Impact on profitability from increase in revenue is more significant because of operating leverage. EBITDA grows almost 20% and margins widen

RIA Valuations Benefit from Higher Profits, Multiples

	Before Tax Bill	After Tax Bill	*% change*
EBITDA	$9,800	$11,620	*18.6%*
Multiple	8.00	8.80	*10.0%*
Implied MVIC	$78,400	$102,256	*30.4%*
Implied AUM multiple	*1.57%*	*1.89%*	*20.8%*

Because of structural change in tax rates, a dollar of EBITDA is worth more, and RIAs have more EBITDA

The combination of these factors could have a significant impact on RIA valuations

Cumulative Impact of Tax Bill is Bullish

Compounding impact of TCJA…

Markets	Fee schedule	Operating Leverage	Multiple Expansion	Higher Valuations
Lower tax rates have driven equity valuations higher, a structural change which may be sustained	Revenues for diversified RIAs may grow faster than AUM because of higher bps charged for equity management	RIAs won't see materially higher fixed costs from stronger revenue, widening margins even after bonuses	Pre-tax valuation metrics common in the industry (AUM, Revenue, EBITDA) will expand because of lower tax rates	More cash flow, better multiples lead to higher valuations for RIAs

Market Corroborates Value Accretion

Bellwether RIAs Have Benefited

Source: S&P Global Market Intelligence; includes AB, LM, TROW, IVZ, BEN, and BLK

As Have Smaller RIAs

Source: S&P Global Market Intelligence; includes CNS, DHIL, GBL, SAMG, WHG, VRTS, WDR, and WHG

Should RIAs Still Be S Corps?

Tax Pass-Throughs

Prior to TCJA, most closely held RIAs were structured as S Corps or LLCs to avoid paying taxes at both the corporate and shareholder level (as is the case with C Corporations)

TCJA largely diminishes this S Corp advantage by reducing corporate level taxes and precluding Qualified Business Income (QBI) deductions for RIA owners that generate over $415K in shareholder income

C vs. S (Before and After)

This used to be easy…

Before TCJA

Assuming 100% payout…

C corporation shareholders paid effective total rates (corporate and individual) of 50% on corporate profits before state taxes

S corp shareholders paid a max rate of less than 40% before state taxes

Now

For 100% payout firms…

C corp shareholders pay a combined rate of about 40%

S corp shareholders pay as much as 37%, but those with a QBI deduction can shave that to under 30%

The math gets more complicated when you retain earnings…

Before TCJA: Fully Distributing RIA

Prior to TCJA, fully distributing S Corps have much higher effective dividend yields thanks to the avoidance of corporate level taxes

In the example here, a fully distributing S corporation has an after tax yield that is 140 basis points higher than if it were organized as a C corp

Tax treatment of S vs. C corporations (before new legislation)

Assumes state tax rate of 0%

	Full Distribution	
	C Corp	**S Corp**
Pre-tax Income	$1,000	$1,000
times: Valuation Multiple	8.0x	8.0x
Indicated Value (Marketable Minority Interest)	$8,000	$8,000
Pre-tax Corporate Income	$1,000	$1,000
less: Corporate Income Taxes	35.0%	0.0%
After-tax Corporate Income	$650	$1,000
Pre-tax Corporate Income	$1,000	$1,000
times: Shareholder Tax Rate	0.0%	39.6%
Shareholder Pass-Through Tax Liability	$0	$396
Portion of After-tax (C corp) Income Retained	0.0%	0.0%
Retained Earnings	$0	$0
Corporate Distributions to Shareholders	$650	$1,000
less: Taxes on C corp dividend at 23.8%	($155)	
less: Shareholder Pass-Through Tax Liability		(396)
After-tax Shareholder Distribution	**$495**	**$604**
After-Tax Yield	**6.2%**	**7.6%**

Before TCJA: Partially Distributing RIA

For partially distributing S Corps, advantage is reduced by lower dividend taxes for C Corp shareholders

Holding the level of retained earnings constant at 50% of C corp earnings, the S corp advantage with regard to after-tax yields narrows to 40 basis points

Tax treatment of S vs. C corporations (before new legislation)

Assumes state tax rate of 0%

	50% Distribution	
	C Corp	**S Corp**
Pre-tax Income	$1,000	$1,000
times: Valuation Multiple	8.0x	8.0x
Indicated Value (Marketable Minority Interest)	$8,000	$8,000
Pre-tax Corporate Income	$1,000	$1,000
less: Corporate Income Taxes	35.0%	0.0%
After-tax Corporate Income	$650	$1,000
Pre-tax Corporate Income	$1,000	$1,000
times: Shareholder Tax Rate	0.0%	39.6%
Shareholder Pass-Through Tax Liability	$0	$396
Portion of After-tax (C corp) Income Retained	50.0%	50.0%
Retained Earnings	$325	$325
Corporate Distributions to Shareholders	$325	$675
less: Taxes on C corp dividend at 23.8%	($77)	
less: Shareholder Pass-Through Tax Liability		(396)
After-tax Shareholder Distribution	**$248**	**$279**
After-Tax Yield	**3.1%**	**3.5%**

Corporate Tax Issues for RIAs after TCJA

TCJA significantly reduced taxes on C corporation earnings

Lower corporate level taxes and lack of QBI deduction for many RIAs reduces the tax advantage of S Corps relative to C Corps

S Corp advantage is further reduced for RIAs that do not fully distribute their earnings to shareholders

Math gets more complicated for RIAs nested inside of corporate ownership, because "dividends received" deduction has been decreased from 80% to 65%

After TCJA: Fully Distributing RIA

Fully distributing S Corps maintain slight advantage over C Corps in the wake of TCJA

The 37% maximum tax rate on S corp earnings is still less than the 21% corporate tax rate and 23.8% dividend tax rate effective for C corporations – in this example a 40 bps advantage

Tax treatment of S vs. C corporations (after new legislation)

Assumes state tax rate of 0%, No QBI deduction

	Full Distribution	
	C Corp	S Corp
Pre-tax Income	$1,000	$1,000
times: Valuation Multiple	8.8x	8.8x
Indicated Value (Marketable Minority Interest)	$8,800	$8,800
Pre-tax Corporate Income	$1,000	$1,000
less: Corporate Income Taxes	21.0%	0.0%
After-tax Corporate Income	$790	$1,000
Pre-tax Corporate Income no QBI deduct)		$1,000
times: Shareholder Tax Rate		37.0%
Shareholder Pass-Through Tax Liability		$370
Portion of After-tax (C corp) Income Retained	0.0%	0.0%
Retained Earnings	$0	$0
Corporate Distributions to Shareholders	$790	$1,000
less: Taxes on C corp dividend at 23.8%	(188)	
less: Shareholder Pass-Through Tax Liability		(370)
After-tax Shareholder Distribution	**$602**	**$630**
After-tax Yield	**6.8%**	**7.2%**

After TCJA: Partially Distributing RIA

Post TCJA, after-tax distribution yields can be lower for partially distributing S Corps with no QBI deduction

In this example, the after-tax S corp yield is 70 bps *less* than the C corp, although fully fleshing out the difference would require accounting for deferred taxes and basis building in the S corp

Tax treatment of S vs. C corporations (after new legislation)

Assumes state tax rate of 0%, No QBI deduction

	50% Distribution	
	C Corp	**S Corp**
Pre-tax Income	$1,000	$1,000
times: Valuation Multiple	8.8x	8.8x
Indicated Value (Marketable Minority Interest)	$8,800	$8,800
Pre-tax Corporate Income	$1,000	$1,000
less: Corporate Income Taxes	21.0%	0.0%
After-tax Corporate Income	$790	$1,000
Pre-tax Corporate Income no QBI deduct)		$1,000
times: Shareholder Tax Rate		37.0%
Shareholder Pass-Through Tax Liability		$370
Portion of After-tax (C corp) Income Retained	50.0%	50.0%
Retained Earnings	$395	$395
Corporate Distributions to Shareholders	$395	$605
less: Taxes on C corp dividend at 23.8%	(94)	
less: Shareholder Pass-Through Tax Liability		(370)
After-tax Shareholder Distribution	**$301**	**$235**
After-tax Yield	**3.4%**	**2.7%**

The QBI Deduction

Yes, this is written in English…

"SEC. 199A. QUALIFIED BUSINESS INCOME.

"(a) IN GENERAL.—In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the sum of—

"(1) the lesser of—

"(A) the combined qualified business income amount of the taxpayer, or

"(B) an amount equal to 20 percent of the excess (if any) of—

"(i) the taxable income of the taxpayer for the taxable year, over

"(ii) the sum of any net capital gain (as defined in section 1(h)), plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year, plus

"(2) the lesser of—

"(A) 20 percent of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year, or

"(B) taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

The amount determined under the preceding sentence shall not exceed the taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

"(b) COMBINED QUALIFIED BUSINESS INCOME AMOUNT.—For purposes of this section—

"(1) IN GENERAL.—The term 'combined qualified business income amount' means, with respect to any taxable year, an amount equal to—

"(A) the sum of the amounts determined under paragraph (2) for each qualified trade or business carried on by the taxpayer, plus

"(B) 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

"(2) DETERMINATION OF DEDUCTIBLE AMOUNT FOR EACH TRADE OR BUSINESS.—The amount determined under this paragraph with respect to any qualified trade or business is the lesser of—

"(A) 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or

"(B) the greater of—

"(i) 50 percent of the W–2 wages with respect to the qualified trade or business, or

"(ii) the sum of 25 percent of the W–2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

"(3) MODIFICATIONS TO LIMIT BASED ON TAXABLE INCOME.—

"(A) EXCEPTION FROM LIMIT.—In the case of any taxpayer whose taxable income for the taxable year does not exceed the threshold amount, paragraph (2) shall be applied without regard to subparagraph (B).

"(B) PHASE-IN OF LIMIT FOR CERTAIN TAXPAYERS.—

"(i) IN GENERAL.—If—

"(I) the taxable income of a taxpayer for any taxable year exceeds the threshold amount, but does not exceed the sum of the threshold amount plus \$50,000 (\$100,000 in the case of a joint return), and

"(II) the amount determined under paragraph (2)(B) (determined without regard to this subparagraph) with respect to any qualified trade or business carried on by the taxpayer is less than the amount determined under paragraph (2)(A) with respect such trade or business,

then paragraph (2) shall be applied with respect to such trade or business without regard to subparagraph (B) thereof and by reducing the amount determined under subparagraph (A) thereof by the amount determined under clause (ii).

"(ii) AMOUNT OF REDUCTION.—The amount determined under this subparagraph is the amount which bears the same ratio to the excess amount as—

"(I) the amount by which the taxpayer's taxable income for the taxable year exceeds the threshold amount, bears to

"(II) \$50,000 (\$100,000 in the case of a joint return).

"(iii) EXCESS AMOUNT.—For purposes of clause (ii), the excess amount is the excess of—

"(I) the amount determined under paragraph (2)(A) (determined without regard to this paragraph), over

"(II) the amount determined under paragraph (2)(B) (determined without regard to this paragraph).

Applicability of the QBI

Long story short, asset managers with incomes greater than $415K don't get QBI

	Entities Other Than Specified Service Businesses	Specified Service Businesses (excludes Architects and Engineers)
Large Operating Businesses *Typical shareholder income > $415k* *50% of W-2 Wages > 20% of pre-tax income*	Shareholders likely eligible for full 20% deduction against pass-through income.	Shareholders not eligible for deduction.
Large Asset Holding Entities *Typical shareholder income > $415k* *50% of W-2 Wages < 20% of pre-tax income*	If compensation base is small, may not be able to take full 20% deduction. Limited to 25% of W-2 wages + 2.5% of cost basis in "qualified property"	Not applicable.
Small Businesses *Typical shareholder pass-through income < $415k*	If shareholder income is <$315k, eligible for full 20% deduction regardless of other limitations. Exceptions phase out ratably to shareholder income of $415k	If shareholder income is <$315k, eligible for full 20% deduction regardless of other limitations. Exceptions phase out ratably to shareholder income of $415k

Most RIAs Will Opt to Remain S Corps

Elimination of QBI deductions for RIAs with over $415K in shareholder income may make C Corp structure more tax efficient for RIAs that do not distribute all their earnings

Since the majority of RIAs typically distribute all of their earnings, S Corp structure retains tax advantage in most cases – even without the QBI deduction

So What Should You Do Now?

Next Steps for RIA Owners

What to do in the wake of TCJA

RIAs have better economics

- Higher AUM
- More revenue
- More profitability

Reconsider fee schedules?

Rethink target margins?

More flexibility in cost structure?

Will compensation models change?

Use increase in profits to fund acquisitions?

Next Steps for RIA Owners

What to do in the wake of TCJA

Reconsider S corp versus C corp

- Ownership
- Dividend Policy
- Compensation

Change compensation to take advantage of QBI deduction?

Maximize "dividends received" deductibility?

Earnings retention more efficient in C corp?

Easier to do C corp asset sale?

Next Steps for RIA Owners

What to do in the wake of TCJA

Higher valuations for RIAs

- Buy-Sell Agreements
- Succession Planning
- M&A

Updated valuations for buy-sell agreements?

Rule of thumb values obsolete?

Succession planning more complex?

Buyers can pay more?

Sellers to expect more?

Questions

About the Presenters

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Matt Crow is president of Mercer Capital and a member of the board of directors.

Matt is active in valuations related to asset management firms and also has broad industry experience accumulated by working with hundreds of client companies during his more than 20 year tenure at Mercer Capital. Along with Brooks Hamner, Matt publishes research related to the asset management industry.

He serves as a course developer for the American Society of Appraisers BV302 course and actively participates in the Appraisal Issues Task Force. In 2014, Matt was elected to serve on the Business Valuation Committee of the American Society of Appraisers.

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Brooks Hamner is a vice president in Mercer Capital's Corporate Valuation Group. Brooks is active in valuation work for asset management firms and has broad industry experience gained since joining Mercer Capital in 2006. Along with Matt Crow, Brooks publishes research related to the asset management industry.

Circumstances giving rise to the engagements Brooks is involved with include corporate planning, employee stock ownership plans, and estate and gift tax planning and other compliance matters. In addition, he actively participates in projects in a litigated context.

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- Assisting RIAs and other asset managers with annual ESOP valuations, fairness opinions, and appraisals for gift and estate tax compliance

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