The Impact of the Tax Cuts & Jobs Act of 2017 for Wholesale Beverage

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BUSINESS VALUATION &
FINANCIAL ADVISORY SERVICES

Could It Be True? – My Distribution Rights Increased in Value as a Result of Tax Reform?

All things held constant, if valuation is primarily driven by expectations for net free cash flow, then business assets have enjoyed a paradigm change in value. That includes the value of beverage distribution rights. But there may be some counterbalancing considerations that make life more complicated and prospective returns thinner for buyers in the new world. The following is reproduced from our website and provides some global insight to our clients on tax reform and valuation.

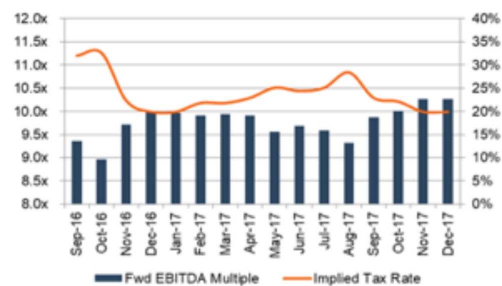
You can access the following in PDF **here**.

Market Backdrop

While equity markets did not make a sharp move upon passage of the tax bill in December 2017, the prospect of significant corporate tax reform was likely a contributing factor to the rally in stock prices during 4Q16 and throughout 2017. The S&P 500 advanced 24% during the period, while the median forward EBITDA multiple for small- and mid-cap shares expanded nearly a full turn, ending 2017 at approximately 10.3x.

Our analysis suggests that, all else equal, the expansion in forward EBITDA multiples corresponds to expectations for a material reduction in corporate tax rates. Data from private company transactions is trickling in; anecdotally, transaction multiples we observed in 2017 often exceeded prior benchmarks.

Consistent with the view that markets are generally efficient; the new lower corporate tax rates seem to have been priced in the market shortly after Election Day. While some doubt regarding the likelihood of passage was evident over the summer months, optimism regarding the tax bill returned to the markets during 4Q17.



Overview of Significant Corporate Changes

Corporate valuations are a function of expected cash flows, risk, and growth. While the reduction in tax rates triggers the most obvious revision to expected cash flows, other provisions of the bill may also significantly influence cash flows for individual companies. Other significant provisions should be evaluated on a company-by-company basis to determine what effect, if any, the changes will have on expected cash flows. Appraisers with deep experience in the relevant industry are best positioned to evaluate the potential effects.

Tax Rate
Corporate tax rate reduced to 21% from 35%

Deductibility of Capital Investment
Through 2022, companies will be able to deduct capital investment as made rather than over time through depreciation charges

Deductibility of Interest
Interest expense deduction limited to 30% of EBITDA through 2021, and 30% of EBIT thereafter

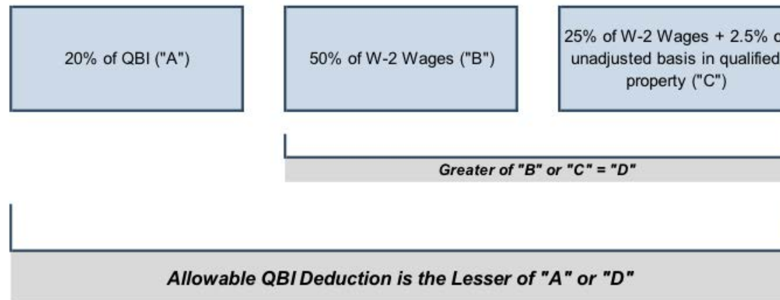
Foreign Income
U.S. taxes due only on U.S. income, with one-time tax to allow repatriation of existing foreign retained earnings

NOL Carryforward Limitations
Max out at 80% of taxable income for year, no expiration

Like-Kind Exchanges
Changes to availability

Treatment of Pass-Through Entities

Lower corporate tax rates reduce the relative tax benefits of the S election. The tax bill provides for a qualifying business income ("QBI") deduction of up to 20% of pass-through income as a means of partially restoring the benefit of the S election. Availability of the QBI deduction is limited by the nature of the subject business and the income of the shareholder.



	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

The Bottom Line

Enterprise Valuation

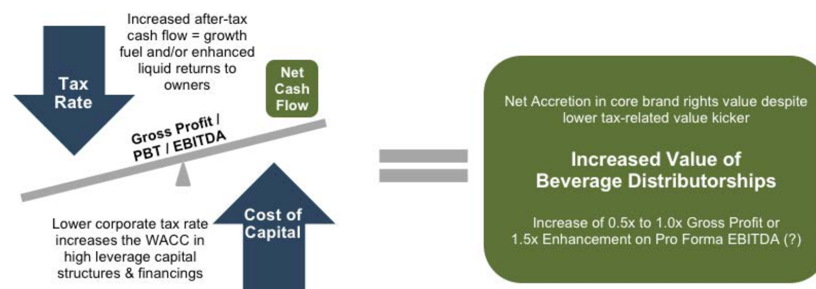
Does a lower corporate tax rate make corporations more valuable, all else equal? Yes. Will all else always be equal? No. Appraisers will need to carefully consider the effects of the new tax law not just on rates, but on growth expectations, reinvestment decisions, the use of leverage, operating margins, and the like for individual companies.

Pass-Through Valuation

What effect does the new tax law have on the value of minority interests in pass-through entities, all else equal? It depends. The resulting differential between corporate and personal rates and the availability of the QBI deduction may cause some business owners to re-evaluate the merits of the S election. The ultimate effect on valuation will depend on the subject company's distribution policy, the length of the expected holding period, and the perceived risk associated with the S election.

Potential Impact on the Value of Beverage Wholesalers

The time-value-of-money is a simple concept. The value today of a future amount is determined by the application of a discount rate. The timing of the cash flows or future events is taken into consideration using the appropriate compounding of the rate. The higher the discount rate used in such an analysis, the lower the value of a given set of future cash flows. The discount rate (weighted average cost of capital) employed to develop an enterprise valuation has changed as result of the change in corporate taxes. And that change actually lowers value when all other things are held constant. However, this small detriment to valuation is overcome by a higher proportional benefit when it comes to the future cash flows. Lower tax rates mean higher future after-tax cash flows. When owners of assets and businesses get to keep more of the earnings of their assets, the assets tend to be worth more (how simple!). An important qualifier to this discussion is that enterprise valuations (and the aggregate underlying assets of enterprises) are almost universally valued using a corporate tax equivalency and not pass-through tax rates as might apply to owners in most beverage wholesaling businesses (LLCs and S corps). The complexity of considerations in pass-through taxation still has many heads spinning. We will maintain a corporate tax mindset for the balance of this discussion because the valuation and investment banking disciplines almost always rely on full marginal tax rates from the corporate world for benchmarking and analysis.



Following is a calculation of value using a SPC method. The calculation on the left reflects a blended marginal corporate tax of 40%. The one on the right reflects a blended 25% rate (state and federal). As mentioned above, the only functional difference in this calculation, aside from the tax rate, is the resulting WACC. Because wholesaler transactions are a highly leveraged affair, the loss of tax hedge on formerly deductible interest expense actually contributes to a higher after-tax cost of debt; and we know that higher discount rates reduce the value of future cash flows. Both WACCs have identical pre-tax interest rates and both rely on the same cost of equity capital, the same capital structure, and the same growth assumption. An increase of 38 basis points of WACC reduces value by about 6%. However, a 25% increase in debt-free net income results in a net value increase of 18%.

	Old Tax Rate		New Tax Rate	
	% of Sales		*% of Sales*	
Sales (+/- 3.0mm CE, Say 10% NA)		$55,000,000		$55,000,000
Cost of Sales		40,425,000		40,425,000
Gross Profit	*26.5%*	14,575,000	*26.5%*	14,575,000
Operating Expenses	*20.0%*	11,000,000	*20.0%*	11,000,000
Operating Profit (EBIT)		3,575,000		3,575,000
Other, Net	*0.25%*	137,500	*0.25%*	137,500
Income (PBT)		3,437,500		3,437,500
Depreciation	*1.00%*	550,000	*1.00%*	550,000
EBITDA(R) [EBIT+Depr+Rent]		$4,125,000		$4,125,000
EBITDA(R) Margin		**7.5%**		**7.5%**
Working Capital	*7.5%*		*7.5%*	
EBIT		$3,575,000		$3,575,000
Blended Federal/State Taxes @	***40%***	(1,430,000)	***25%***	(893,750)
Debt-Free Net Income		2,145,000		2,681,250
+ Depreciation & Amortization		550,000		550,000
- Capital Expenditures		(550,000)		(550,000)
- Working Capital		(61,875)		(61,875)
Free Cash to Enterprise		2,083,125		2,619,375
Enterprise Value @ Cap Rate	*6.0%*	**$34,719,000**	*6.4%*	**$41,056,000**
TEV using Cash Flow (DCF/SPC)		$34,719,000		$41,056,000
Assumed Tangible Assets		(4,125,000)		(4,125,000)
Intangible Assets (Rights)		$30,594,000		$36,931,000
GPx of Distribution Rights		**2.1x**		**2.5x**
Implied TEV ÷ Adjusted Standalone EBITDA		**8.4x**		**10.0x**

The preceding examples assume a simplistic "standalone" valuation that does not capture consolidation efficiencies. Note that the effective gross profit and EBITDA multiples are higher with revised tax rates. Could it be true that a simple flip of the tax switch contributes another half turn of gross profit and almost one and a half turns of EBITDA? That is exactly what the math says based on the assumptions employed. Maybe all the legacy rules of thumb need to be reinterpreted? Let's acknowledge that the influence on valuation from tax reform is favorable. But, let's also dig a bit deeper to find some potential push back.

Industry advisors have long pushed the idea that benefits associated with the tax amortization of acquired distribution rights contribute to the value of the intangible assets. If we compare the present value of the tax benefits on a before and after basis we see that the tax benefit ($7.2 million) is imputed to represent about 24% of the legacy value of rights ($30.6 million). The updated value of the rights is 21% higher at $36.9 million, but the increment of value associated with tax amortization is only 14.4%, which is a 26% reduction in the tax component of value. If the present values of the tax benefits were netted from the total rights values, the change in the core value of the rights would be 35% higher. If we dig a little deeper into the moving parts of the new tax rules, we'll see that the loss of tax hedge on amortization and the new limitations on interest deductions could be affecting buyer's returns in such a way as to provide a counterbalance to the increased business and asset value implied by the reduction in taxes. In other words, if a buyer is pressed to pay the higher value but the investment returns (IRR) on such a transaction are actually lower, then the higher ask may be countered with a counterbalancing bid and the net result may be something in between.

Legacy Value & Taxes	
Assumed Amort	
Yrs @ 15	PV @ 7.5%
$30,594	◄ *Dist Rts*
Tx Effect	PV Tx
$816	$759
816	706
816	657
816	611
816	568
816	529
816	492
816	458
816	426
816	396
816	368
816	343
816	319
816	296
816	276
PV Tx Ben ►	$7,204
% of Rts ►	*23.5%*

Updated Value & Taxes	
Assumed Amort	
Yrs @ 15	PV @ 7.9%
$36,931	◄ *Dist Rts*
Tx Effect	PV Tx
$616	$571
616	529
616	490
616	454
616	421
616	390
616	362
616	335
616	311
616	288
616	267
616	247
616	229
616	212
616	197
PV Tx Ben ►	$5,303
% of Rts ►	*14.4%*

Are buyers persuaded by returns or hung up on notional value in the dollar and gross profit sense? Extending the preceding examples, in a hypothetical standalone purchase, a buyer could finance 90% of a $34.7 million legacy enterprise purchase and realize an IRR of 28% using reasonable modeling assumptions. If a buyer paid the higher enterprise valuation implied by the lower tax rate ($41.1 million), then under substantially the same modeling assumptions the IRR drops to 21%. This is not to say that such an IRR would lead a buyer to reduce the purchase consideration, but the loss of tax hedge from amortization and the new limits on interest deductions dilute the buyer's return. Arguably in a strategic transaction the limitation on interest deductions could be moot if the buyer is healthy and not burdened with pre-existing debt from a new facility of from a shareholder buyout. These are some of the reasons why a buyer's profile can be significant to a seller's expectations.

Summary

The mechanics of business valuation, particularly the discounted net cash flow method (or its SPC cousin) will throw off higher valuations using the new lower tax rates. Whether the wholesaler transaction markets will affirm this has yet to be discovered. Interestingly, some early financial modeling suggests that strategic deals require careful assessment to determine the impact on investment returns. The new tax rules and rates could be problematic for internal family transfers and for sales between family owners and their non-family successors. No doubt there is more due diligence and study required. Of course, time will tell us more and force the refinement of our thinking.

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Specifically, Mercer Capital provides beverage wholesalers and distributors across the nation with corporate valuation, transaction advisory, financial reporting valuation, and related services.

For over 35 years, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world.

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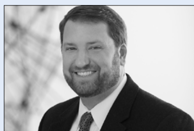

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