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Value Matters™

Issue No. 1, 2018
Six Different Ways to Look at a Business

Along the road to building the value of a business it is necessary, and indeed, appropriate, to examine at the business in a variety of ways. Each provides unique perspective and insight into how a business owner is proceeding along the path to grow the value of the business and on if/when it may be ready to sell. Most business owners realize the obvious events that may require a formal valuation: potential sale/acquisition, shareholder dispute, death of a shareholder, gift/estate tax transfer of ownership, etc. A formal business valuation can also be very useful to a business owner when examining internal operations.

So, how does a business owner evaluate their business? And how can advisers or formal business valuations assist owners examining their businesses? There are at least six ways and they are important, regardless of the size of the business. All six of these should be contemplated within a formal business valuation.

1. **At a point in time.**

   The balance sheet and the current period (month or quarter) provide one reference point. If that is the only reference point, however, one never has any real perspective on what is happening to the business.

2. **Relative to itself over time.**

   Businesses exhibit trends in performance that can only be discerned and understood if examined over a period of time, often years.

3. **Relative to peer groups.**

   Many industries have associations or consulting groups that publish industry statistics. These statistics provide a basis for comparing performance relative to companies like the subject company.

4. **Relative to budget or plan.**

   Every company of any size should have a budget for the current year. The act of creating a budget forces management to make commitments about expected performance in light of a company's position at the beginning of a year and its outlook in the context of its local economy, industry and/or the national economy. Setting a budget creates a commitment to achieve, which is critical to achievement. Most financial performance packages compare actual to budget for the current year.

5. **Relative to your unique potential.**

   Every company has prospects for “potential performance” if things go right and if management performs. If a company has grown at 5% per year in sales and earnings for the last five years, that sounds good on its face. But what if the industry niche has been growing at 10% during that period?
6. Relative to regulatory expectations or requirements.

Increasingly, companies in many industries are subject to regulations that impact the way business can be done or its profitability.

Why is it important to evaluate a company in these ways? Together, these six ways of examining a company provide a unique way for business owners and key managers to continuously reassess and adjust their performance to achieve optimal results.

A formal business valuation can communicate the company’s current position in many of these areas. Successive, frequent business valuations allow business owners and key managers the opportunity to measure and track the performance and value of the company over time against stated goals and objectives.
The Tax Cuts and Jobs Act of 2017 was signed into law by President Trump on December 22, 2017. President Trump calls the bill the biggest tax cut in American history, and there were substantial reductions in both corporate and personal income tax rates.

The tax reduction act will impact C corporations as well as pass-through entities. This article focuses only on C corporations and looks at the marginal impact of the change. In the words of that famous economist, “all other things will be held equal” as we examine the potential impact of the new tax law on privately owned C corporations.

Corporate Taxes are Lowered

Upon Mr. Trump’s election in late 2016, the stock markets began to anticipate that he would follow through on his campaign promise to cut business taxes in order to make American corporations more competitive internationally.

As of early February 2018, the broader market indices are up well more than 20% since late 2016.

That is the result in the public markets. Will valuations of privately owned C corporations automatically rise 20%? At this point, with the passing of December 31, 2017, thousands of private companies across the nation must be valued for a variety of reasons. Business appraisers have to begin to consider the impact of the tax act on the coming wave of appraisals.

Basic Valuation Equation

We have spoken about the “basic valuation equation” a number of times.

\[ \text{Value} = \text{Earnings} \times \text{Multiple} \]
All appraisers have to do is to determine the relevant Earnings and then, the relevant Multiple to arrive at Value. We’ve also said many times that if valuation were actually that easy, we and many others would not have enjoyed great careers in the appraisal profession. Other things are not always equal….

C Corporation Earnings

We know that the federal corporate marginal tax rate was lowered from 35% to 21%. Given the impact of state taxes on C corporation earnings, appraisers have historically used a blended federal/state tax rate of 38% to 40%. For our purposes here, assume that the old blended tax rate was 38%.

With the reduction in the federal rate, there will be an accompanying reduction in the blended tax rate. Assume that the new blended federal/state tax rate for C corporations is 25%.

What happens to expected earnings when we compare the new tax rate with the old rate? For a given dollar of pre-tax earnings, less taxes will be paid, so after-tax earnings will rise. We see this in Figure 2.

For a given dollar of Earnings Before Interest and Taxes,

Figure 2

<table>
<thead>
<tr>
<th>Component</th>
<th>Old Tax Law</th>
<th>New Tax Law</th>
<th>% Chg</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBIT</td>
<td>$10,000</td>
<td>$10,000</td>
<td>0.0%</td>
</tr>
<tr>
<td>Less Taxes</td>
<td>38.00%</td>
<td>25.00%</td>
<td>-34.2%</td>
</tr>
<tr>
<td>Debt-Free Net Income</td>
<td>$6,200</td>
<td>$7,500</td>
<td>21.0%</td>
</tr>
</tbody>
</table>

which can also be called debt-free pre-tax earnings, debt-free net income is $6.2 million under the old tax law and rises some 21% to $7.5 million under the new law. Looking at the basic valuation equation above, Earnings should be up under the new tax law so, other things being equal, value should rise.

After-Tax/Debt Valuation Multiples

Business appraisers develop discount rates and valuation multiples in virtually every valuation. We do so using one of several forms of what we call the Adjusted Capital Asset Pricing Model.

In Figure 3, we develop discount rates for a generalized and hypothetical private company which is organized as a C corporation. We calculate discount rates under both the old tax law and the new tax law. The assumptions leading to the equity discount rate are not controversial, and the concluded equity discount rate is 14.9% under both laws.

Figure 3

<table>
<thead>
<tr>
<th>Components</th>
<th>Components</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Treasuries (current 20-year rate)</td>
<td>2.80%</td>
</tr>
<tr>
<td>2 Equity Risk Premium</td>
<td>5.50%</td>
</tr>
<tr>
<td>3 Beta</td>
<td>1.2</td>
</tr>
<tr>
<td>4 Beta-Adjusted ERP</td>
<td>6.60%</td>
</tr>
<tr>
<td>5 Size Premium</td>
<td>4.00%</td>
</tr>
<tr>
<td>6 Company-Specific Risk</td>
<td>1.50%</td>
</tr>
<tr>
<td>7 Equity Discount Rate</td>
<td>14.90%</td>
</tr>
</tbody>
</table>

The discount rate is geared to reflect risks associated with a reasonably attractive privately owned C corporation. The assumptions for the components of the discount rate are selected so as not to be controversial. Note that in leading to the equity discount rate above, nothing changes, at least directly as result of the tax act. To be clear, there is no direct impact from the tax reduction on any of the components (see Lines #1-#6 above) of the equity discount rate (Line #7) under either scenario (Figure 3 or Figure 4).

We use the equity discount rate as one component of the build-up to reach the enterprise level discount rate, or weighted...
average cost of capital (WACC). The second component of WACC begins with the pre-tax cost of debt, which we have assume here to be 6.0% (Line #8). We calculate taxes based on the old and new tax laws.

The after-tax cost of debt under the old law is 3.72%, while the after-tax cost of debt under the new law is 4.50% (Line #10). In a way, this is counter-intuitive, but the tax shield is lower under the new law so the after-tax cost of debt rises. This means that there will be an upward bias on the after-tax WACCs of C corporations under the new law.

The assumed capital structure above is 75% equity and 25% debt (Lines #7 and #10), a reasonable and general assumption. There will be a modest upward bias on the WACC as result of higher after-tax interest expenses.

On Line #11, we see that the WACC under the old law is 12.11%, while the WACC rises to 12.30% under the new law. This is not a lot of change (1.6%). We assume a long-term growth rate of 3%, another reasonable assumption (Line #12). This growth rate is subtracted from the WACCs to achieve the debt-free capitalization rates of 9.11% (old) and 9.30% (new) on Line #13. Again, this change is small (up 2.1%).

The debt-free net multiples are derived on Line #14 as 10.98x (old) and 10.75x (new). As with the change in cap rates immediately above, the change in debt-free multiples is also small (down 2.1%).

Summarizing the implications of the new tax act on C corporation private companies to this point, we see that there should be little change in after-tax multiples and a significant change in after-tax earnings.

### Before-Tax/Debt Valuation Multiples

We now look at the pro forma impact on enterprise multiples of EBIT and EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) using a continuation of the analysis found in Lines #7-#19 above. We will focus on EBITDA for the most part.

Keep in mind that since both EBIT and EBITDA are before taxes, there will be no change to these measures of cash flow based solely on the tax law change.

We can convert after-tax capitalization rates into before-tax cap rates as shown on Lines #13-17 by dividing them by one minus the (old and new) tax rates. At this level, we see a significant difference in cap rates. The EBIT cap rate under the old law is 14.69% while the EBIT cap rate under the new law is 12.40% (Line #16), reflecting a reduction of 15.6%.

The lower EBIT cap rate under the new tax law suggests that the implied EBIT multiple will be significantly higher than
under the old regime. The old EBIT multiple is 6.81x and the new EBIT multiple is 8.06x, or 18.4% higher (Line #17).

An EBITDA depreciation factor of 1.25x reflects the average relationship between EBIT and EBITDA for a substantial portion of the public company marketplace.

*The EBITDA Depreciation Factor measures the relationship between EBIT and EBITDA and is one measure of capital intensity. The higher the factor, the greater is EBITDA in relationship to EBIT. The factor can be calculated: Factor = EBITDA/EBIT.*

We use this general factor of 1.25x on Line #18 in Figure 4 to convert EBIT multiples to EBITDA multiples. The implied EBITDA multiple under the old tax law was 5.45x, while the multiple under the new tax law is 6.45x, or a turn higher (Line #19) under the assumptions above and assuming that nothing else in the world changes other than the tax rate.

**Impact on Value**

We have now looked at debt-free after-tax cap rates and multiples under both the old tax law and the new law. And we have looked at pro forma changes in before-tax multiples of EBIT and EBITDA. What happens to value? Figure 5 looks first at the capitalization of debt-free net income and then of EBITDA. If our theory makes sense, then the analysis results should also make sense.

We see on Lines #20 and #25 that EBIT is unaffected by the change in corporate tax rates. We assume above that EBIT is $10.0 million initially, and it remains the same before and after the corporate tax reduction. On Lines #21 and #22, we see that the tax reduction results in a substantial increase in after-tax income. As previously noted, debt-free net income rises from $6.2 million to $7.5 million on a pro forma basis (again, other things being equal).

With the only modest reduction in the debt-free net income multiple (Line #23), the rising income swamps the negative impact of multiple reduction, and value rises from $68.1 million to $80.6 million, or 18.4%.

On an after-tax basis, the story is that earnings rise substantially, driving a large net increase in pro forma value.

Lines #25–#27 calculate EBITDA based on the assumed EBIT and the assumed EBITDA depreciation factor of 1.25x. EBITDA under these assumptions is $12.5 million. The EBITDA multiple rises from 5.45x to 6.45x, or 18.4%.

Since there is no change in EBITDA under the new law, the implied EBITDA multiple increase of 18.4% yields a new, pro forma value of $80.6 million, or the same as calculated below with after-tax multiples. That makes sense because we are valuing the same company.
Initial Observations

From the Figure 5 analysis, we can make a number of observations of the impact of the new tax law on cash flow, valuation multiples, and value. All summaries are based on the economist’s assumption that all other things – other than the tax law change – remain equal. Summarizing for after-tax valuations:

» With a reduction in the federal/state tax rate from 38% to about 25%, there will be a substantial increase in after-tax cash flow.

» The tax law change impacts the standard estimation of WACC only modestly through the increased after-tax cost of debt and lower tax shield from the lower tax rates.

» From an appraiser’s viewpoint, there is little impact on the traditional building-up of after-tax discount rates and WACCs (or at least, the increase is very modest).

» From an appraiser’s viewpoint, there will be a need to focus sharply on the prospective impact of lower taxes as well as other relevant factors, which, in the real world, are not held equal.

» Other things being equal, value should rise for privately owned C corporations as a result of the lowering of corporate tax rates. How much values will rise will depend on actual expected taxes as well as the other factors that will impact expected future cash flows for private companies being valued.

The reduction in corporate tax rates does not impact broad pre-tax measures of cash flow like EBIT and EBITDA.

» Other things being equal, EBITDA multiples will rise to reflect the higher values resulting from higher after-tax cash flows.

» Appraisers must be careful, however, in developing EBITDA multiples. The use of multiples from historical transactions involving “comparable” companies may be invalid for a few years until the majority of future-recent transactions are recorded under the new tax law with lower corporate rates.

» More appraisers are likely to begin to formulate EBITDA multiples using methods similar to those used above.

Figure 6 is from a presentation on Mercer Capital’s website. The figure examines smaller (non-financial) public companies over the period from late 2016 to the present.

The analysis is another of those “other things being equal” things. Travis Harms went back to September 2016 before the election.

» The analysis looks at the S&P 1000, or non-financial public companies with about $500 million to $5 billion in market capitalization.

» At each month-end, the stock prices for each company and their forward estimates of EBITDA were downloaded.

» Simplistically, the model solved for the implied corporate tax rate that matched the then-current stock prices for each company in light of its forward EBITDA projections.
The implied tax rate started in the 30%-plus range, and fell quickly to the 20% range on optimism of a quick passage of the tax bill. As the year passed and the new tax bill did not, the implied tax rate rose back toward 30% as the year progressed. Later in the year, as the expectations for a successful passage of the bill increased, the implied tax rate fell to the range of 20%. The markets did indeed anticipate the passing of the new tax act and lower corporate taxes.

The result is that, as shown in Figure 6, the broader markets are up more than 20% since late 2016. Forward EBITDA multiples, as calculated in the analysis above, have increased about a turn (or about 10%) to 10.3x at the end of 2017.

The real world examples are not as neat as our pro forma analysis above. However, in the real world, other things are never equal. The markets take into account many factors and recognize these in their collective valuations of corporate America. What’s different in the real world? Many things, including:

» The shareholders may not receive all of the benefit of lower taxes.

» Many corporations have announced $1,000 and $2,000 bonuses to be paid to all of their employees, and more companies are likely to do so. Corporate managers who are compensated based on earnings may also benefit somewhat.

» Some corporations have announced increases in corporate giving to charitable causes that will absorb some of the benefit.

» Corporations have announced new capital expenditures that will absorb some of the benefit of the tax savings. The shareholders certainly hope to benefit in the future, but the markets will take their time in evaluating these plans.

» Some corporations with market power may demand that their suppliers “give up” a portion of the benefit of their expected lower taxes in lower prices. Some clients have already received calls on this issue from their dominant customers.

### Conclusion

The bottom line is that there are no simple answers to the question of post-tax reform valuation of privately owned C corporations. The focus of appraisers, however, will likely be more on the Earnings portion of the basic valuation equation, since the reform has little impact on the after-tax multiples.

Appraisers will, we believe, begin to seek new ways of developing pre-tax multiples. Reliance upon market transactions will be questionable for some time to come, since all historical transactions (i.e., prior to year-end 2017) occurred under a different tax regime.

Business owners who rely on so-called “rules of thumb” to estimate the value of their businesses had best seek professional advice. The valuation world has changed, indeed.

Business owners who have fixed price buy-sell agreements or formula-pricing buy-sell agreements should be rushing to have them updated to substitute appraisal processes. It should be clear from this article that there could be significant surprises in store for fixed-prices and formulas to determine pricing for buy-sell agreements.

We conclude with the note that this analysis relates only to privately owned C corporations. There are many other ramifications of the new tax law that we and others will be examining in the coming months.

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Beach Reading: Notice of Proposed Rulemaking – Qualified Business Income Deduction

Struggling to find a page-turning read for that next fall break escape? May we recommend the 184 pages of blissful decadence that comprise the Internal Revenue Service’s August 2018 Notice of Proposed Rulemaking (NPR) regarding the Qualified Business Income (QBI) deduction under the Tax Cuts & Jobs Act (TCJA). Like a tightly wound murder mystery, the regulations weave a complex web. Tax code sections take the place of characters, the regulation’s intricacies unspooling as the narrative continues, relationships between Tax Code sections becoming (somewhat) clearer as the story (i.e., the regulation) progresses. As the NPR continues its inexorable march, certain storylines (i.e., planning opportunities) are forestalled, yet the NPR creates a glimmer of other opportunities.

In addition, certain W-2 income and asset limitations exist that may limit the 20% deduction. Lastly, individuals with income below certain levels may escape the SSTB and W-2 income/asset limitations; therefore, these owners would receive the 20% deduction whereas owners with higher incomes would not. The NPR provides guidance regarding, among other items, the definitions of QTBs and SSTBs.

Other Issues

While businesses not deemed to be SSTBs are definitely eligible for the 20% Qualified Business Income deduction, several other items covered by the NPR may be of interest to business owners:

Qualified Trade or Business Definition

An entity must be a Qualified Trade or Business to receive the 20% QBI deduction. From the TCJA, however, it was unclear if a QTB must be a “Section 162 trade or business.” While the Internal Revenue Code and regulations contain various definitions of a “business,” Section 162 contains a relatively restrictive definition. Unfortunately for taxpayers, the NPR adopts the Section 162 definition.

While Section 162 has existed for many years, the regulations and case law interpreting the provision remain somewhat vague. One significant concern is that certain real estate entities will not be deemed Section 162 trades or businesses, therefore becoming ineligible for the 20% QBI deduction. For example, entities holding properties subject to triple net leases may face difficulties meeting the Section 162 requirements.

The Abridged Version of the NPR/TCJA

Internal Revenue Code Section 199A provides a 20% deduction against the income reported by owners of sole proprietorships, partnerships, and S corporations. If only tax code provisions could be described in one sentence, though. The deduction may be taken against income generated by a Qualified Trade or Business (QTB). A QTB, in turn, is any business, other than a Specified Service Trade or Business (SSTB). This deduction does not apply to SSTBs involved in performing services in accounting, actuarial services, law, health, financial service, brokerage services, investment management, performing arts, athletics, and consulting among others. Note, engineering and architecture businesses are not treated as service business, and therefore, would qualify for a QBI deduction.
The TCJA’s Definition of an SSTB

Entities providing professional services generally are deemed SSTBs. The business reality, though, is that some companies provide both a tangible product (like a widget) and services that would meet the definition of an SSTB (such as educational services regarding widgets). Will a company offering some consulting services, no matter how small a share of revenues, be deemed an SSTB? Under the TCJA, it was unclear. The NPR creates a de minimis exception for companies with small amounts of service revenues, although the thresholds appear relatively low to us.

The TCJA also includes a “catch-all” provision deeming as SSTBs any businesses for which the reputation or skill of its owners or employees is a principal asset. This broad provision potentially captures a large swath of small businesses; for example, the reputation of a restaurant’s chef may result in the restaurant being deemed an SSTB. This result appears inconsistent with the TCJA’s statutory intent, and the NPR significantly limits the scope of the catch-all provision.

The “Crack and Pack” Strategy

Commentators noted that the TCJA created a tax planning opportunity for businesses deemed SSTBs. For example, consider a law firm that owns a building in which it operates. The law firm is an SSTB and its partners ineligible for the 20% deduction. The partners could transfer the building to a new real estate holding company, which is not deemed an SSTB. Therefore, the law firm partners have shifted income – via rent payments from the law firm to the real estate holding entity – from the SSTB (the law firm) to an entity qualifying for the QBI deduction (the real estate entity).

Alas, the IRS cracked down on the “crack and pack” strategy. The NPR provides that income from a commonly-controlled entity that provides services to an SSTB is ineligible for the 20% deduction. However, the NPR may not entirely foreclose on all planning strategies. While the NPR limits the QBI deduction for commonly-controlled entities, commonality is deemed to exist if the businesses share 50% or more ownership. Therefore, the law firm may transfer its building to an entity owned equally by the law firm partners, an accounting firm’s partners, and a physician group. Since common control does not exist (i.e., neither the attorneys nor the accountants nor the physicians control more than 50% of the real estate’s firms ownership), the owners of the various services firms would be eligible for the 20% deduction on the real estate entity’s earnings. To bankers, business reorganizations triggered by the deduction limitations applicable to SSTBs may trigger lending requirements.

Conclusion

Like a good novel, the NPR’s “plot” is not fully resolved – some questions remain unanswered and multiple interpretations of other provisions are possible. Perhaps a sequel to the NPR is in order.
Mercer Capital in the News

Upcoming Speaking Engagements

Jay D. Wilson, Jr., CFA, ASA, CBA
“How FinTech Can Help Create Value & Enhance Profitability”
Moss Adams Community Banking Conference, Huntington Beach, CA

Z. Christopher Mercer, FASA, CFA, ABAR
“Active Passive Appreciation Analysis Panel” and “EBITDA Single Period Income Capitalization for Business Valuation”
ASA Advanced Business Valuation and International Appraisers Conference, Anaheim, CA

Jay D. Wilson, Jr., CFA, ASA, CBA
M&A Roundtable Discussion
Fi FinTech Roundup, Fredericksburg, TX

Z. Christopher Mercer, FASA, CFA, ABAR
“Active Passive Appreciation”
AAML Florida Bar Family Law Section Retreat, Nashville, TN

Karolina Calhoun, CPA/ABV/CFF
“Getting Command of the Numbers in a Valuation”
TSCPA Forensic & Valuation Services Conference, Brentwood, TN

Scott A. Womack, ASA, MAFF
“Creativity in Financial Elements of a Collaborative Divorce”
IACP Networking and Educational Forum, Seattle, WA

Three professionals are on the schedule at this year’s AICPA Forensic & Valuation Services Conference in Atlanta, GA
Karolina Calhoun, CPA/ABV/CFF
“Collaborative Law the New Horizon Panel” and “Lifestyle Analysis/Pay & Need Analysis”

Z. Christopher Mercer, FASA, CFA, ABAR
“Active Passive Appreciation Panel” and “Valuation Tax Panel”

Travis W. Harms, CFA, CPA/ABV
“Introduction to Monte Carlo Simulation in Financial Reporting” and “Net Cash Flow Complications”

Timothy R. Lee, ASA
“Control Issues in ESOP Purchase Transactions”
ESOP Association Las Vegas ESOP Conference & Trade Show, Las Vegas, NV

Karolina Calhoun, CPA/ABV/CFF
“Corporate & Business Transactions From a Legal and Financial Perspective”
The Memphis Chapter of Tennessee Society of CPAs, Memphis, TN

Please join us in congratulating Karolina Calhoun, CPA/ABV/CFF on her President-Elect appointment to the Memphis Chapter of the Tennessee Society of CPAs for the 2018-2019 year.
Mercer Capital’s ability to understand and determine the value of a company has been the cornerstone of the firm’s services and its core expertise since its founding.

Mercer Capital is a national business valuation and financial advisory firm founded in 1982. We offer a broad range of valuation services, including corporate valuation, gift, estate, and income tax valuation, buy-sell agreement valuation, financial reporting valuation, ESOP and ERISA valuation services, and litigation and expert testimony consulting. In addition, Mercer Capital assists with transaction-related needs, including M&A advisory, fairness opinions, solvency opinions, and strategic alternatives assessment.

We have provided thousands of valuation opinions for corporations of all sizes across virtually every industry vertical. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement. Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation on behalf of their clients.

Contact a Mercer Capital professional to discuss your needs in confidence.