Tax Reform: Repercussions for Corporate Credit

January 2018

After a year of anticipation, Congress has passed comprehensive tax reform. The House and Senate have generated a plan that excites equity investors and corporate credit investors alike, given improved earnings projections and cash-flow expectations.

Miriam Legrand
Vice President, Corporate Credit Research

KEY HIGHLIGHTS FOR CORPORATES

	TAX CUTS AND JOBS ACT	PREVIOUS SYSTEM
Corporate Tax rate	21% (taking effect in 2018)	35%
Expense of Capital Investments	Immediately write off or "expense" the cost of new investments for at least 5 years	Depreciation
Interest Expense for C-Corporations	Partially limited 30% EBITDA through 2021 and 30% of EBIT starting 2022 (excludes Utilities and Real Estate)	Allowed
Tax System	Territorial with 5% provision in 2018 and 10% in 2019 and thereafter	Worldwide system
Alternative Minimum Tax on Corporations	Repeal	20%
Repatriation	One-time tax on existing profit of 15.5% on liquid assets and 8% on illiquid assets	Taxed at US tax rate of 35%
Net Operating Losses	Limit to 80% and no carryback	Carryback 2 years and Carryforward 20 years

As of December 19, 2017. Source: US House of Representatives Document Repository

Sectors

Corporations in the US are taxed at the marginal rate of 35% - a rate which, some may argue, makes them less competitive versus global peers. But with the use of certain tax credit and deductions, the effective rate for companies may differ. The implications of reform vary across sectors but beneficiaries are likely to include sectors with the highest effective tax rates like industrials and telecom, as seen in the table at right.

The energy and utilities sectors have the highest level of capital expenditures which should benefit from the bill's immediate expensing feature allowing them to write off new investment.

AVERAGE EFFECTIVE TAX RATE (%) BY GICS SECTOR

FIERA CAPITAL CORPORATE UNIVERSE	
Industrials	36.46
Telecommunication Services	33.93
Consumer Discretionary	31.76
Energy	28.45
Financials	27.57
Consumer Staples	27.51
Utilities	26.18
Health Care	23.38
Information Technology	22.22
Materials	20.29
Real Estate	0.69
Grand Total	**27.17**

Source: Bloomberg as of December 13, 2017

Sectors like technology and healthcare that have large cash balances should benefit from the repatriation that is likely to ensue, though foreign profit taxation could mitigate some of the tax benefit and impact corporate strategies. Of the ten companies with the largest cash holdings, most are in the tech, healthcare and industrials sectors, and a lot of the cash balances are held overseas, with some companies holding up to 80-90% of their cash and marketable securities overseas. As this cash is repatriated we will monitor the impact it could have across the market particularly as most of it is invested in investment grade short term corporates and Treasuries.

CORPORATIONS WITH LARGEST CASH BALANCES

Ticker	Cash Balance ($mm)
AAPL	261,516
MSFT	133,399
GOOGL	94,713
GE	40,490
CSCO	67,974
ORCL	70,653
AMGN	41,551
F	39,109
QCOM	19,627
GILD	42,128

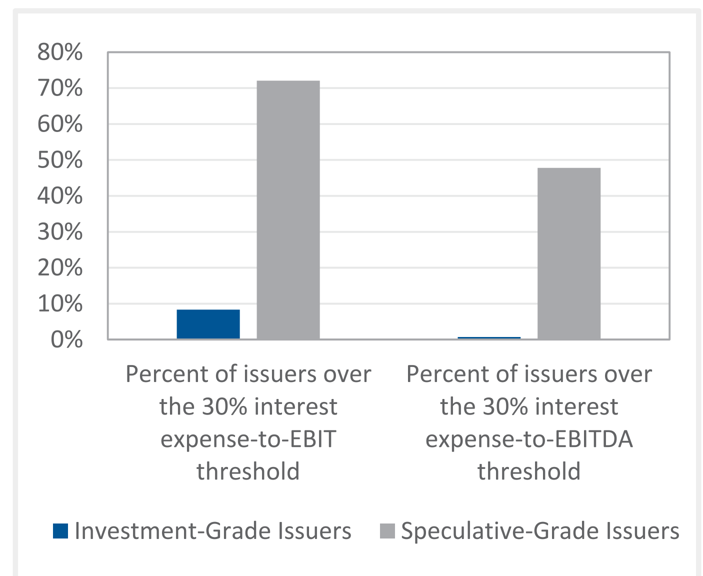
Source: Company Reports as of October 6, 2017

While financials look to benefit, some names carry large deferred tax assets (an overpayment of taxes) on their balance sheets. At a lower tax rate, these assets may need to be written down in the quarter that tax reform comes into effect. Investors should not be surprised to see headlines associated with this when some of the large US financial institutions report earnings next quarter. However this loss is a one-time, non-cash event, and in the long run these institutions should still benefit from an overall reduced tax rate as well as the underlying companies to whom they lend.

Interest Expense Deductibility

While the changes to interest expense deductibility should have minimal impact to investors of investment grade companies, we will likely see effects in the broader speculative-grade market. As opposed to the majority of speculative grade issuers, most investment grade names generate interest expense that falls well inside of the 30% of EBITDA cap, which means that they should continue to be able to fully deduct interest expense. We may see a larger impact starting in 2022 when the cap is measured against EBIT furthering the limits on deductibility.

ISSUERS OVER THE INTEREST EXPENSE CAP



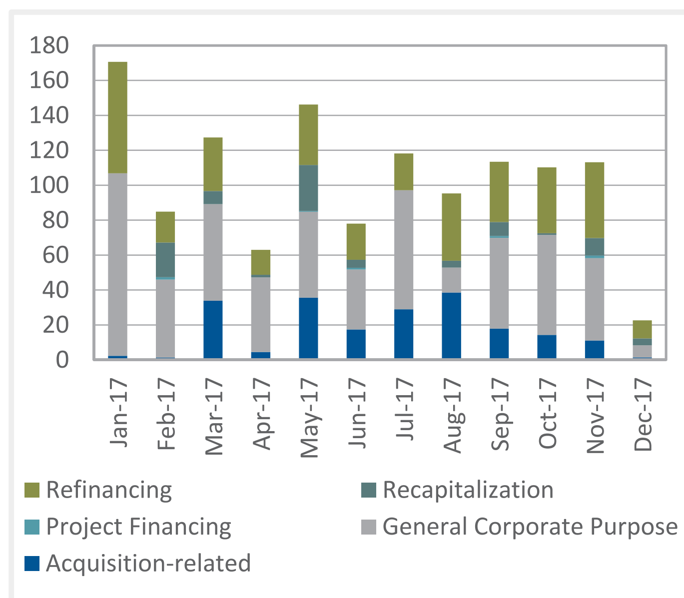
Source: S&P Global Ratings (based on three years average forecasted data as of Dec 1, 2017)

Issuance Impact

High grade corporate bond issuance is expected to be moderately low in 2018 compared to 2017. While tax reform should reduce some funding needs driven by the ability of companies to tap into overseas cash, Merger & Acquisition ("M&A")-related supply should see a pick up in the year ahead. We saw reduced M&A-related funding in 2017, largely due to tax policy uncertainty. This was a positive for investors in sectors like pharmaceuticals

which saw slim supply relative to beginning of the year forecasts, as companies were waiting for more clarity on tax reform before pursuing large scale M&A. But activity has started to pick up in sectors like telecom, media and technology and a potential large deal between a drug retailer and a managed care company is in the pipeline which could weigh on investor positions in those sectors.

HIGH GRADE ISSUANCE VOLUME ($B) BY PROCEEDS



Source: LCD as of December 31, 2017

Ratings Implications

While corporate ratings should benefit overall from the improved cash flow profile on reform measures, there is one area where ratings may be vulnerable. The ratings at S&P could be the most vulnerable because the agency nets out cash when calculating debt ratios. This results in better leverage metrics and stronger ratings. Companies may shift financial policies to favor more shareholder-friendly actions, similar to how they rewarded shareholders during the last tax holiday, which results in less cash on their balance sheets. The result of this action could be less favorable leverage metrics and in turn downward pressure on ratings. The technology and pharmaceutical sectors, with their typically higher cash reserves, stand to be at greatest risk. We will continue to monitor corporate strategies on tax reform changes.

While we believe the effects of tax reform will be generally positive for corporate credit overall, we will be closely watching corporate behavior as the impacts of this reform begin to reverberate throughout the markets.

FIERA CAPITAL

IMPORTANT DISCLOSURES

GENERAL DISCLOSURES

This material is proprietary to Fiera Capital, Inc. ("Fiera Capital"). This document is intended for information purposes only and may not be relied upon in evaluating the merits of investing in any Fiera Capital investment vehicle or portfolio.

The information provided reflected Fiera Capital's views as of the date of this presentation. Such views are subject to change at any point without notice. Some of the information provided herein is from third party sources and/or compiled internally based on internal and/or external sources and are believed to be reliable at time of production but such information is not guaranteed for accuracy or completeness and was not independently verified. Fiera Capital is not responsible for any errors arising in connection with the preparation of the data provided herein. No representation, warranty, or undertaking, express or implied, is given as to the accuracy or completeness of such information by Fiera Capital or any other person; no reliance may be placed for any purpose on such information; and no liability is accepted by any person for the accuracy and completeness of any such information.

These materials are not intended as investment advice or a recommendation of any security or investment strategy for a specific recipient; investments or strategies that may be described herein are provided as general market commentary. Nothing herein constitutes an offer to sell, or solicitation of an offer to purchase, any securities, nor does it constitute an endorsement with respect to any investment area or vehicle.

FORWARD-LOOKING STATEMENTS

Discussions regarding potential future events and their impact on the markets are based solely on historic information and Fiera Capital's estimates and/or opinions and are provided for illustrative purposes only. A number of the comments in this document are based on current expectations and are considered "forward-looking statements." Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of Fiera Capital's best judgment at the time this document is compiled, are subject to change at any time without prior notice, cannot be guaranteed as being accurate, and any obligation to update or alter forward looking statements as a result of new information, future events, or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual investment strategy/style, security, asset class, markets generally, nor are they intended to predict the future performance of any Fiera Capital investment vehicle or portfolio.