

The Impact of Tax Reform on the Investment-Grade Credit Market

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In December, President Trump and Republican members of Congress passed the most significant changes to the U.S. tax system since the Reagan administration in 1986. While the changes are extensive and widespread, there are four key provisions that are likely to have the largest impact on the investment-grade corporate credit market: 1) a reduction in the corporate income tax rate, 2) a limitation on the deductibility of interest, 3) the expensing of capital expenditures and 4) the forced repatriation of untaxed foreign earnings.

Starting in 2018, U.S. corporations will be subject to a flat corporate income tax rate of 21%, down from the current top tax rate of 35%. This reduction is projected to have a substantial impact on earnings, but will not necessarily immediately improve corporate leverage, which is calculated using earnings before interest, taxes, depreciation and amortization, or EBITDA. However, more after-tax cash flow is certainly supportive of credit. A lower corporate tax rate also dilutes the tax shield on debt. As a result, there has been a material increase in liability management exercises with companies electing to take a loss on retiring high dollar-priced bonds in 2017 when that loss is more valuable from a tax perspective. The lower tax rate is also causing companies to write down their deferred tax assets. While these write-downs may result in a one-time earnings hit, they should not impact credit fundamentals.

The new tax law also changes the rules regarding the deductibility of interest expense. Under the current law, interest

expense is fully deductible. Under the new law, deductions are disallowed for interest in excess of 30% of EBITDA. Starting in 2022, the rule becomes more restrictive as EBIT, or earnings before interest and taxes, will be used instead of EBITDA to determine the allowable limit. Furthermore, there is no grandfathering of existing debt. This change should have limited implications on the investment-grade credit market as a relatively small percentage of the investment-grade universe has interest expense above the 30% limit. High yield companies may see more of an impact and debt-funded acquisitions, such as leveraged buyouts, may become less attractive. However, the negative effects will be partially offset by the lower tax rate discussed above.

The new law is also attempting to promote more rapid economic growth through increased investment spending on new plants and equipment by changing the rules around the expensing of capital expenditures. Under the current law, capital expenditures can be expensed on a sliding scale (40% in the first year, 30% in the second, 20% in the third, etc.). The new law allows for immediate expensing of 100% of the cost of certain new and used business assets placed into service before 2023. After 2023, the bonus depreciation percentage will be phased out by 20% per year, going to 0% in 2027. While an increase in capital expenditures negatively affects a company's free cash flow in the short term, the positive effect on economic growth is supportive of investment-grade credit over the intermediate to longer term.

Perhaps the provision that may have the most impact on the investment-grade corporate market is the forced one-time repatriation tax on accumulated, previously untaxed foreign earnings. The earnings that are held as cash or cash equivalents will be taxed at 15.5% while all other repatriated earnings will be taxed at 8%. This tax will be due over eight years.

The sectors most impacted by this change are Information Technology and Health Care, which combined account for 85% of total untaxed overseas cash. Without untaxed access to this cash, many of these companies have issued debt over the last several years to fund dividends and share buybacks. However, now that companies have access to the overseas cash, it is not necessarily a given that they will automatically look to reduce domestic debt levels. First, in most cases, bonds are a relatively cheap form of capital; the average yield on the issuance from the top five holders of overseas cash is 2.5%. Secondly, in this low-spread and low-yield environment,

companies no longer feel as though they are being compensated for maintaining an ultra-high-quality balance sheet. As a result, instead of paying down debt, it is more likely companies will continue to prioritize distributing cash to shareholders or start looking for attractive merger-and-acquisition (M&A) opportunities. Under this scenario, any decline in new-issue bond volumes because of repatriation will be more than offset by an increase due to M&A activity. Furthermore, gross debt/leverage in Information Technology and Health Care will likely have peaked, but net debt/leverage will increase as cash balances decline.

Collectively, these changes to the tax code are a modest positive for the investment-grade credit market. Overall, credit fundamentals will benefit from continued economic growth, but event risk in the form of mergers and acquisitions is expected to increase, making active management that much more important.

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