

Corporate Tax Reform Implications

MARCH 2018

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Firm Overview

Aetos Capital is an independent firm, providing investment advisory services through Aetos Alternatives Management, LLC ("Aetos"). Since the firm's inception, Aetos has been a leader in constructing fully customized hedge fund solutions for a broad range of institutional clients.

Founded

2001

Firm AUM¹

\$11.0 billion

Leadership

Anne Casscells
Co-President & Chief Investment Officer

Michael Klein
Co-President & Chief Risk Officer

Locations

New York, New York
Menlo Park, California

EXECUTIVE SUMMARY

The Tax Cuts and Jobs Act ("Tax Act") became law on December 22, 2017, representing the largest overhaul of the US tax code in over 30 years. While there were notable changes to the individual tax code, the Tax Act's most significant impacts relate to the corporate tax code. These provisions will have both far reaching and disparate impacts on US corporations, resulting in some immediate changes to corporate profitability and onshore cash balances as well as many longer-term impacts as they influence management decisions around optimal capital structures and corporate strategy.

Aetos believes the Tax Act will lead to significant new opportunities for alpha generation across a number of hedge fund strategies. In our view, the beta opportunity has passed given that, at a market level, the benefits of lower corporate taxes have already been priced into equity valuations. However, since the impact of the new tax law differs widely company by company, the alpha opportunity, based on fundamental analysis, should be robust. In the following, we will first lay out the most significant changes to the corporate tax code and subsequently assess their potential impact on several major hedge fund strategies.

SIGNIFICANT CHANGES

The changes to the corporate tax code as a result of the Tax Act were extensive and are beyond the scope of this piece to detail in full. However, in our opinion, the most significant changes are as follows:

- **Corporate Tax Rate Reduction:** Change from a progressive structure with a 35% top rate to a "flat" tax structure with a 21% rate
- **Foreign Earning Repatriation:** Mandatory deemed repatriation of undistributed (offshore) foreign earnings and profits that will be subject to a one-time charge of 15.5% for cash assets and 8% for non-liquid assets, that can be paid over 8 years
- **Territorial System for Offshore Earnings:** Foreign earnings by US companies will generally no longer be subject to US taxes, due to a 100% deduction on certain qualified dividends from foreign subsidiaries
- **Interest Deduction Limitation:** Net interest expense deductions will be limited to 30% of EBITDA through 2021 and then limited to 30% of EBIT thereafter
- **Change to Net Operating Loss (NOL) Deductibility:** Corporations will no longer be allowed to use a two year lookback period for utilizing NOLs and will be limited in utilizing NOL carryforwards to 80% of taxable income. However, there will no longer be any limitation on how long NOLs can be carried forward
- **100% Immediate Deduction for CapEx:** Including used property and equipment

¹ As of December 31, 2017

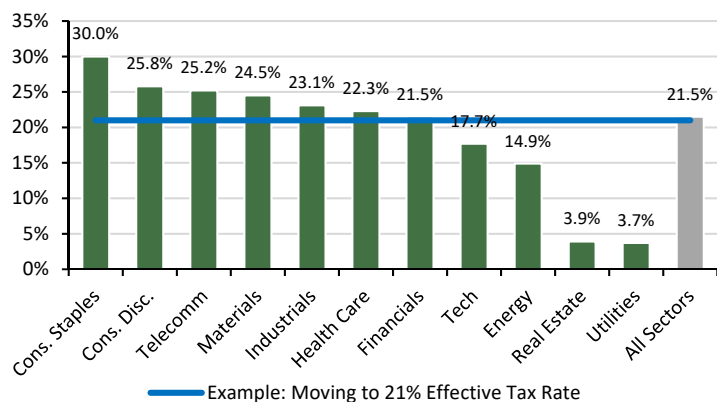
IMPLICATIONS FOR HEDGE FUND STRATEGIES

While there is disagreement about whether the corporate tax legislation will bring about the improvements that its proponents claim—in terms of global competitiveness, increased jobs, better wages for US workers, etc.—it is clear to us that it is sufficiently meaningful to result in material changes to corporate earnings and corporate strategy. The law also brings with it a good deal of complexity and, due to the haste with which it was written, ambiguity that will provide ample opportunities for creative tax lawyers and accountants to exploit loopholes leading to unintended outcomes. Apart from such creative tax avoidance schemes, we believe that this combination of change and complexity should lead to numerous opportunities for alpha generation. In the sections below, we detail some of our thoughts as to how the Tax Act may lead to opportunities across three major hedge fund strategies: Long/Short Equity, Event Driven and Distressed Credit.

Long/Short Equity

While the Tax Act has already had an impact on long/short equity portfolios, we anticipate that most of the alpha opportunities arising from tax reform are ahead of us. Prior to the Tax Act, there was significant disparity in the effective tax rate paid across different industries (*Chart 1*). Beginning last fall, as the likelihood of tax reform increased, stocks began responding to the potential for lower corporate taxes, with those sectors and companies with the highest effective tax rates experiencing outperformance.

Chart 1: Trailing 12-Month Realized Corporate Tax Rate



Source: Morgan Stanley, 2016.

As tax reform began to look more likely, we observed some long/short managers adjust their exposures, particularly within their short portfolios. For example, many trimmed short positions in challenged retail businesses in recognition that these stocks might significantly rally given their status as US domiciled companies with mostly domestic revenue sources.

In general, the market’s early reaction to tax reform has been to reward those companies that historically paid high taxes, without

differentiating between differences in industry structures and the competitive positioning of companies. In industries with many companies and low concentration, the end result of the Tax Act might be a combination of lower product prices and higher labor costs, rather than increased profits. In fact, we have seen a number of managers add back to their retail shorts in early 2018 after concluding that much of the benefit of tax reform is likely to be competed away.

In other situations, however, the market may be underestimating the benefits of the Tax Act, adding to the strength of a manager’s long thesis and leading the manager to increase position sizing. Charter Communications is a good example, as the company enjoys a robust competitive position given that most of its customers lack compelling alternatives to its broadband Internet cable product. As a result, it is likely that most of Charter’s tax windfall will drop to the bottom line.

Beyond competitive dynamics, there are potential alpha opportunities arising from the uncertainty created by the legislation. Many companies noted on their earnings calls in February that they are still in the process of assessing the full impact of the legislation on their own circumstances and have decided to hold off on adjusting their earnings outlook. Since sell-side analysts are often hesitant to deviate from management guidance significantly, there could be opportunities for managers who conduct detailed analysis to uncover situations where consensus expectations are too low.

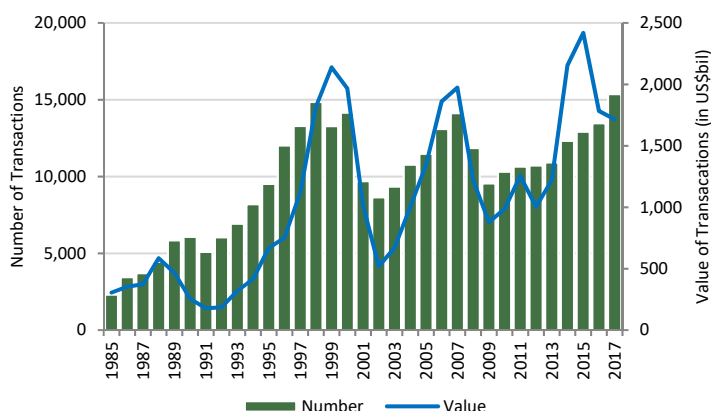
The Tax Act’s provision around repatriation of offshore earnings is also likely to create confusion as there will be large discrepancies between cash flow and reported earnings for some companies. This will persist for some time as companies generally recognized the full impact of the repatriation tax on offshore earnings in December 2017, but will be paying the actual cash taxes incrementally over the next eight years. This opacity may benefit managers who have the expertise to look beyond the headline valuation and earnings to the true cash flow of a business.

Event Driven Equities

The most immediate impact of the Tax Act is likely to be a pickup in both the number of transactions and volume of US M&A (*Chart 2*). The Tax Act increases the free cash flow of most US companies, which gives them more financial flexibility to make acquisitions. In addition, the mandatory repatriation of overseas profits will result in approximately \$2 trillion of cash coming back onshore in 2018. Analysts expect that the largest uses of this cash will be returning it to shareholders via dividends and share buybacks. In fact, some expect that share buybacks may exceed \$800 billion in 2018, an

increase of \$270 billion over 2017.² Dividends are also expected to rise at a historically high rate of nearly 10%. Nonetheless, even after these payouts, many companies will be sitting on record cash balances. We expect the increased flexibility afforded by excess unrestricted cash, combined with synchronized global growth, to likely result in a re-acceleration in M&A activity. This should benefit managers that pursue merger arbitrage, as larger volumes tend to keep deal spreads relatively wide.

Chart 2: US Merger and Acquisition Volume



Source: Institute for Mergers, Acquisitions and Alliances

The Tax Act is also likely to impact other types of corporate activity such as asset sales. Historically, companies largely avoided selling divisions due to the cost of paying a 35% tax rate on the purchase price in excess of their basis. Additionally, many divisions were too small to be wholly spun off as independent companies. With the tax rate now just 21%, however, more companies are likely to explore asset sales of units that are deemed not core to their business. Purchasers are also more likely to explore asset deals as there is the extra incentive of capital investments being immediately and fully deductible from earnings. This is likely to lead to a pickup in the overall level of corporate activity and an increase in the opportunity set for event arbitrage managers. While asset sales do not typically provide a “clean” or easy way to arbitrage the target versus acquirer as with public company merger arbitrage, the nature of acquisition accounting often leads to misunderstandings where managers can profit by applying fundamental and rigorous research.

We have already seen the passage of the Tax Act impact one merger arbitrage situation in particular – AT&T/Time Warner. Since Time Warner is primarily a domestic US company with onshore revenues, it paid a high effective tax rate in the past and will benefit significantly from the new lower corporate tax rate. This change resulted in a material improvement in downside case of a deal break in the AT&T/Time Warner merger, and results in a much more attractive asymmetry to the payout profile of the investment. Several managers have chosen to increase their position in Time Warner as a result of this change, while also balancing this against

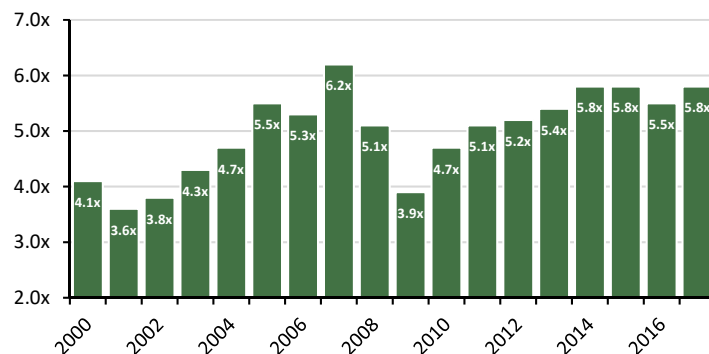
² Source: JP Morgan research, March 2018.

the risks associated with the government’s current opposition to the transaction.

Distressed Credit

The near-term impact of the Tax Act on distressed credit strategies is likely to be smaller, but we believe it may lead to more stressed and distressed companies during the next credit downturn. There are a significant number of companies that have been heavily levered as part of LBO transactions over the past few years (Chart 3). Similarly, non-LBO corporate leverage has also crept up in recent years due to the widespread availability of cheap high yield financing. The Tax Act’s limitation on interest expense deductibility and prohibition on net operating loss carrybacks are potentially significant for this set of levered companies.

Chart 3: LBO Total Leverage (Total Debt/EBITDA)



Source: S&P Capital IQ LCD
Data as of September 30, 2017

In the past, companies in distress have frequently utilized the NOL carryback to generate cash.³ If a company had paid taxes within the past two tax years and then began losing money, it could utilize these new NOLs to generate a refund of previously paid taxes. This cash could serve as an additional buffer to give a company more time to negotiate with its creditors or be used to help cover some of the administrative expenses of a bankruptcy process. Without this source of cash, companies on the brink of financial distress may have fewer options when negotiating with creditors.

Similarly, the limitation on interest expense deductibility to 30% of EBITDA through 2021 and 30% of EBIT thereafter is a negative for financially troubled companies that suffer from an excessive debt load. Although interest deductibility is only relevant to companies with positive earnings, certain companies with positive but deteriorating profitability will have less cash flow available to pay down debt as a result of this rule change. The net result of these two changes is to potentially reinforce the downward spiral of financially troubled companies.

³ Source: Baker McKenzie, Tax Reform Part 1, November 2017.

To see why companies with high leverage ratios are at risk, let us consider two examples. Company A has leverage of 6x and a cost of debt of 7%. As a result of the Tax Act, it will lose deductibility on about 30% of its interest expense. However, this company may still come out ahead from tax reform due to the new 21% flat rate. However, Company B, with leverage of 8x and a cost of debt of 9%, almost certainly will be negatively impacted and experience lower overall profitability versus the old rules where there were no limits on interest deductibility. For this reason, while the average high yield company will come out ahead as a result of these reforms, the most highly levered companies will likely be worse off. In fact, a recent analysis by JP Morgan concluded that 73% of CCC-rated companies will be worse off after netting the multiple impacts of these tax changes.⁴

Over the longer-term, private equity firms may limit the amount of leverage they apply to future purchases and other highly levered companies may find ways to adjust their debt to equity mix to optimize their taxes (such as by issuing preferred stock). In the near to medium term, however, we expect these changes in tax policy to be a modest positive for distressed credit investors. On the margin, these new rules may increase the number of financially troubled companies and the severity of their situations, particularly during the next downturn.

CONCLUDING THOUGHTS

Although the Tax Act is now law, its impacts on corporate strategy and capital structures are just beginning. Management teams and their advisors—legal and accounting experts and investment bankers—will be devoting significant time in the coming quarters to re-optimize their strategies given this new set of rules. While we have already seen some big changes from the Tax Act, such as a spike in corporate share buyback announcements, much is yet to unfold. Some impacts, such as increased corporate activity, are predictable. Others, however, are as of yet unknown. We suspect that the most skilled hedge fund managers will be able to capitalize on the changes in different ways in the coming quarters, with event driven managers particularly well suited to benefit.

⁴ JP Morgan research, December 2017.

DISCLOSURES

Hedge fund investing involves substantial risks, including the risk of loss of invested capital. Hedge fund investments are typically made through investments in illiquid, unregulated investment funds that employ sophisticated investment techniques, often involving derivatives and leverage, in a wide range of financial instruments and markets. These investments entail a wide variety of risks, which remain substantial notwithstanding the risk management practices we employ in selecting and monitoring the funds in which we invest. Past performance is not indicative of future returns.

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