

How Tax

REFORM

will boost middle market M&A

The reduction in the corporate tax rate from 35 to 21 percent will give strategic buyers more cash to spend on acquisitions.

Gary Wallace

After months of anticipation and countless negotiations, Congress finally passed the Tax Cuts and Jobs Act at the end of 2017. Hailed as the most significant change to the U.S. tax code in more than 30 years, Republicans hope that the new legislation will boost the economy by spurring job growth, driving wages higher, and increasing corporate investment in the country. It is too soon to tell whether these goals will be met, but we do know this legislation contains several provisions that have the potential to significantly boost capital investments in the middle market and increase deal flow across the United States. It is important to know the impacts of the new tax provisions to adjust strategies accordingly and reduce tax burdens.

One of the most anticipated changes of the act included a reduction in the corporate tax rate from 35 percent to a flat 21

percent and the repeal of the corporate alternative minimum tax. Both changes became effective after Dec. 31, 2017 and will increase the after-tax profitability of corporations.

We have already seen that some corporations are using these extra savings as compensation incentives for employees but corporations will also be looking for making additional investments in the business which sets the stage for M&A activity. Corporations will seek better multiples by obtaining a return on investment, and with tax reductions, focusing on enhanced cash flow by acquiring middle market companies – especially those that require or produce accelerated tax benefits for “qualified property,” qualified property, as defined by the act, includes any tangible property with a depreciable life of 20 years or less. This includes computer software, machinery, land, property, and other tangible assets.

The act provides an immediate bonus deduction for 100 percent of the cost of these assets for through 2022. More importantly, the deduction is available for both new property and property acquired from a different taxpayer. In other words, property acquired through an acquisition now qualifies. Businesses looking to reduce their tax burden will find these provisions particularly attractive and will be inclined to use excess cash to make investments in middle market companies. Certain asset intensive sectors that will be big winners include pharma, manufacturing, construction, and others that hold and/or produce qualified property.

An important aspect to note about this increased depreciation provision is that acquirers and sellers will need to structure deals as asset acquisitions to receive the upfront deductions. Historically, most acquirers have preferred this form of deal structure. However, it is not always the most advantageous for the corporate seller. Therefore, middle market acquirers will need to carefully consider how to make deals more attractive given that the act does add additional depreciation benefits for the buy-side of the deal.

For transactions with significant intangible value, the reduction in the corporate rate to 21 percent may mean that the tax impacts of an asset acquisition are not quite as valuable as it was under a 35% corporate tax rate regime. This is because the tax value of intangible amortization (generally over 15 years) has a lower cash flow impact. Of course, acquirers may still prefer the legal protections with an asset acquisition over a stock purchase.

Another important provision on the buy-side of deals is the impact of tax rate changes to pass-through companies. Pass-through corporate structures such as partnerships and LLCs make up 90 to

95 percent of the middle market and are a preferred structure for private equity deals because it alleviates “double taxation,” and allows the flexibility of an exit.

The act provides beneficial deductions to certain pass-throughs including a deduction of up to 20 percent of their business income. However, pass-throughs that fall into a “specified service trades or businesses” such as health, law, consulting, athletics, financial services and brokerage services won’t qualify for the deduction if the taxpayer’s taxable income is more than \$207,500 (\$415,000 for married individuals filing jointly).

For those seeking to acquire a company, these favorable deductions could present challenges for targets that are non-qualifying businesses. Private equity sponsors will need to consider these challenges and evaluate the tax profile of the acquired business as well as the other provisions of the act, which may impact the timing of a possible exit due to carried interest limitations, new limitations on business interest deductions and net operating losses, and the other tax attributes of the company being acquired.

The act also includes a one-time repatriation tax on accumulated earnings held overseas. The tax rate is 15.5 percent on earnings held in cash and 8 percent on the remaining earnings and is paid over a period of years. The repatriation of these funds by major corporations will likely be invested in one form or another to avoid additional taxes in the future. This could set up a tremendous opportunity for the middle market because corporations may likely use their repatriated cash to acquire companies that complement their core business. Again, like the corporate rate reduction, the act’s impact on freeing capital for investments will put the burden on acquirers to put that capital to work in the U.S. which may

result in enhanced multiples.

One final consideration for acquirers and sellers in 2018 is what might happen in Washington. As of now, it is possible that Democrats could retake one, if not both houses of Congress in this year’s election cycle. As we all witnessed from the coverage of the act’s passage, Democrats are not fans of this new legislation, which some have called a “corporate give-away.” If Democrats become the majority, they might reverse the recently passed tax legislation, bringing back closer parity in individual vs. corporate tax rates, which means acquirers need to analyze the current situation, but also think about the future impacts of their decisions. This is especially true as it relates to corporate structures. If Democrats raise the corporate tax rate, the ability to convert a corporation back into a pass-through structure would become much more tax costly.

There is tremendous sentiment that M&A activity in the middle market will surpass 2017 levels this year. Both the size of deals and the quantity of those deals will likely be much higher as both sellers and acquirers look to take advantage of the act’s pro-growth provisions. It is important to realize all of the benefits and potential hurdles the act contains so that all parties will benefit from their transactions.

Even through the Act will have substantial impacts on many negotiating decision points, the business community is hopeful that Congress’ goal becomes reality and that the Act does indeed boost the U.S. economy.

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Most Active Mid-Market Investment Banks by Volume

KPMG closed more middle-market M&A deals than any other investment bank in the world. PricewaterhouseCoopers, Rothschild & Co., Houlihan Lokey and BDO were among the top 5 in deal volume.

Investment Bank	Number of Deals
KPMG	337
PricewaterhouseCoopers	278
Rothschild & Co	273
Houlihan Lokey	207
BDO	201
Ernst & Young LLP	195
Deloitte	189
Lazard	185
JP Morgan	160
Goldman Sachs & Co	160
IMAP	157
Morgan Stanley	141
Oaklins (FKA M&A Intl Inc)	126
Credit Suisse	125
Mizuho Financial Group	117
Industrial & Comm Bank China	116
Lincoln International	116
Citi	114
Baker Tilly International	112
Sumitomo Mitsui Finl Grp Inc	110
Barclays	101
Moelis & Co	96
Stifel/KBW	95
Raymond James Financial Inc	94
BNP Paribas SA	90
Generational Equity	88
Clairfield International	87
KBS Corporate Sales Ltd	87
Jefferies LLC	86
Piper Jaffray Cos	85
Alantra Partners SA	77
Bank of America Merrill Lynch	74
Duff & Phelps	74
Evercore Partners	73
UBS	71
RBC Capital Markets	68
Deutsche Bank	68
Clearwater International	68
Global M&A	62
Grant Thornton	61
Benchmark International	58
Macquarie Group	57
CFI	57
CITIC	55
Nomura	52
Robert W Baird & Co Inc	51
BMO Capital Markets	47

Investment Bank	Number of Deals
KeyBanc Capital Markets Inc	47
Credit Agricole CIB	46
Globalscope	46
PNC Financial Services Group	44
Daiwa Securities Group Inc	43
Haitong Securities Co Ltd	42
UniCredit	42
Sandler O'Neill Partners	41
RSM Corporate Fin LLP	39
TD Securities Inc	36
HSBC Holdings PLC	35
Stephens Inc	35
Natixis	35
China Securities Co Ltd	33
ING	33
Capitalmind	33
GCA Corp	32
Stout Risius Ross Inc	32
Itau Unibanco	31
William Blair & Co	31
BCMS Corporate Ltd	31
Cooperatieve Rabobank UA	31
China International Capital Co	30
China Merchants Securities Co	30
Wells Fargo & Co	30
Mitsubishi UFJ Financial Group	30
Societe Generale	30
Kon SpA	29
PJT Partners Inc	27
CBRE Holding SAS	26
Chartwell Financial Advisory	26
Greenhill & Co, LLC	25
Investec	24
Canaccord Genuity	22
Somerley	22
Livingstone Partners	22
GF Securities	21
Smith Cooper Corporate Finance	21
Concentro Management AG	21
Mazars SA	21
Translink Corporate Finance	20
SunTrust Banks	20
CIBC World Markets Inc	19
AGC Partners	19
Prairie Capital Advisors Inc	19
Kingston Corporate Finance Ltd	18
Cenkos Securities PLC	17

Most Active Mid-Market Investment Banks by Value (\$bil)

J.P. Morgan's total dollar value of completed middle-market M&A deals was the highest of any investment bank in the world. Goldman Sachs & Co., Morgan Stanley, Rothschild & Co. and Credit Suisse were among the top 5 in deal value.

Investment Bank	Value (\$bil)
JP Morgan	47.2
Goldman Sachs & Co	41.3
Morgan Stanley	41.1
Rothschild & Co	32.3
Credit Suisse	28.8
Citi	26.5
Barclays	26.3
Lazard	26.3
Bank of America Merrill Lynch	23.9
Jefferies LLC	18.9
Deutsche Bank	18.6
BNP Paribas SA	16.4
UBS	16.0
Evercore Partners	15.7
Moelis & Co	15.4
RBC Capital Markets	15.4
Houlihan Lokey	14.5
PricewaterhouseCoopers	11.9
CITIC	11.9
BMO Capital Markets	11.8
Ernst & Young LLP	11.4
Stifel/KBW	10.9
Nomura	10.7
TD Securities Inc	10.3
Macquarie Group	10.2
HSBC Holdings PLC	10.2
KPMG	9.5
Industrial & Comm Bank China	8.5
China Securities Co Ltd	8.1
Wells Fargo & Co	8.0
Piper Jaffray Cos	7.7
Sandler O'Neill Partners	7.4
Centerview Partners LLC	7.4
Robert W Baird & Co Inc	6.8

Investment Bank	Value (\$bil)
Haitong Securities Co Ltd	6.8
Raymond James Financial Inc	6.7
China International Capital Co	6.7
CIBC World Markets Inc	6.5
Deloitte	6.4
Daiwa Securities Group Inc	5.4
Credit Agricole CIB	5.2
National Bank of Canada Fin'l	5.1
China Merchants Securities Co	5.1
Sumitomo Mitsui Finl Grp Inc	4.9
Mediobanca	4.9
Guotai Junan Securities	4.6
Itau Unibanco	4.3
Stephens Inc	4.2
PNC Financial Services Group	4.0
Mizuho Financial Group	3.9
Greenhill & Co, LLC	3.7
Investec	3.5
SEB	3.3
KeyBanc Capital Markets Inc	3.2
William Blair & Co	3.2
GCA Corp	3.2
Banco BTG Pactual SA	3.2
CBRE Holding SAS	3.2
Standard Chartered PLC	3.1
Somerley	3.0
Cowen & Co	3.0
Huatai Securities Co Ltd	3.0
ING	2.9
Duff & Phelps	2.8
Scotiabank	2.7
Canaccord Genuity	2.7
Natixis	2.6
Societe Generale	2.5

Editor's Note:

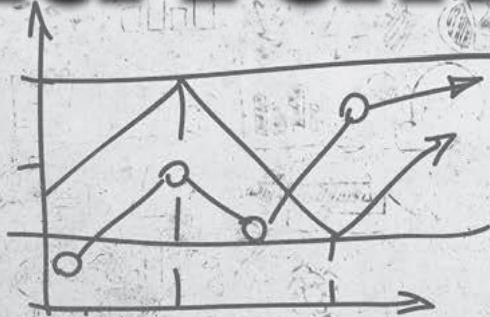
To measure activity in the middle market, Mergers & Acquisitions looks at transactions that fulfill several requirements: Deals must have a value of roughly \$1 billion or less, or an undisclosed value; and they must be completed (not just announced) within the timeframe designated. For this ranking, we included deals throughout the world. Excluded from our charts are: recapitalizations; self-

tenders; exchange offers; repurchases; stake purchases; and transactions with undisclosed buyers or sellers. The data provider is Thomson Reuters, which updates its databases continuously. We use the data available at press time. For this article, data was collected on Feb. 15, 2018.

Guest Article



The Analytics Advantage



Digital technologies, such as artificial intelligence and analytics, play a key role in helping human deal analysts sort through vast amounts of data. By J. Neely

Digital technology has fundamentally transformed the M&A market, changing the way companies approach deal strategies – from the targets they’re chasing to the processes they have in place for deal execution and integration.

Wanted: digital assets

Companies are increasingly turning to M&A to strengthen their digital footprints, acquiring multiple businesses in quick succession to gain technologies they don’t currently possess. Digital fuels growth, and many large organizations are recognizing that they can’t build the digital capabilities they need as quickly as they would like to achieve that growth organically. Instead, they’re looking outside for new, emerging players to acquire innovation and technologies to stay competitive.

For example, Siemens has invested \$10 billion in software companies since 2007 to help fulfill its digital strategy. As a result, in 2016, Siemens’ digital business generated around \$4.6 billion, 12 percent more than 2015—with double digit growth predicted through 2020.

Digital needs are fast rivaling traditional reasons in spurring M&A events across all industries. Accenture Strategy research shows that acquiring new capabilities and the need for next-gen tech are on par with more traditional M&A triggers such as expanding into geographic markets or industries.

A new M&A approach

To make digital acquisitions a success and have them contribute to

new business growth, companies need to transform their M&A approach from the get-go. More than three-quarters of executives agree they cannot rely on traditional M&A capabilities for digital deals. These deals require a different mindset, and different toolkit – companies getting it right are digitizing their processes from target screening to valuation, through to discovery, negotiation, integration and beyond. More than 60 percent of companies are already using a different pre-deal team and evaluation for digital transactions.

Digital technologies also allow companies to generate better insights faster, run a smoother process and extract more value from M&A. Analytics and applied intelligence play a key role in helping human deal analysts sort through vast amounts of data—from financials, to company communications, social media and customer sentiment.

Digital wealth for all

To realize an acquisition’s full potential, companies also need to spread that digital savvy across the organization. Currently, research shows most companies are failing to infuse the cultural DNA of their digital deals into the wider organization, with almost two-thirds keeping digital acquisitions as a stand-alone business.

An increasing number of acquiring executive teams are realizing the value of harvesting the DNA that their agile upstarts bring, but integration must be done thoughtfully, not monolithically. For example, one approach that has proven successful is to foster a culture of cultures that allows new acquisitions

to thrive in the parent company’s ecosystem, while creating commercial and infrastructure linkages that enable collaboration around market opportunities. Additionally, as companies acquire multiple digital entities, some may find stringing them together to create a new capability and meld the best of all cultures could create a competitive advantage.

- Develop a distinct process for digital M&A. From target screening to valuation, discovery and negotiation, a modified playbook can be a huge advantage.
- Determine the appropriate level of integration, to scale new business growth. The more digital acquisitions a company makes, the more necessary holistic integration strategy becomes.
- Double down on technologies like analytics and artificial intelligence to improve end-to-end capabilities for all acquisitions—traditional and digital. Companies will generate better insights faster, streamline the process and extract more value from M&A.

M&A activity related to gaining digital capabilities will only continue to increase. Those who move quickly to bring their company into the new with digital technologies are best positioned to reap the rewards.

J. Neely is managing director and global M&A lead within Accenture Strategy, where he focuses on working with clients across the consumer, retail and industrial sectors.

Spotlight: Lower Mid-Market

Q4 purchase price multiples up more than 19 percent year over year

Valuation multiples continued to surge in the fourth quarter of 2017, according to GF Data. Deal pricing pushed upward to an average mark of 8.1x EBITDA, a 19.3% increase over the year-ago fourth quarter (6.8x) and a 7.0% jump from 3Q '17 (7.5x). The 8.1x mark is a 28.5% increase over the GF Data historical average multiple of 6.3x, which includes deals dating back to 2003.

Completed deal volume for the fourth quarter was up 19.3% over the corresponding quarter last year, and 41.7% higher than Q3 2017. GF Data reports on transactions completed by a pool of 201 private equity funds and other sponsors on transactions they complete in the \$10-250 million Total Enterprise Value (TEV) range, with TEV/Adjusted EBITDA multiples of 3-15x.

The active fourth quarter is notable given the anecdotal impression that some sellers once again pushed off end-of-year closings in anticipation of federal tax changes. Historically, fourth quarter volume is the highest volume quarter of the year, and averages approximately 25% higher volume than the following Q1.

Deals involving above average financial performers and businesses with higher enterprise values continue to command demonstrable premiums. The quality premium for above-average performers was 27.1% in Q4 2017, off 10.3 percentage points from the prior year period but still a remarkable 18.5 percentage point increase over the historical average. The premium for deals with larger enterprise values in 4Q 2017 was 2.3x EBITDA, up 24.4% from last year's Q4 and up 73.3% from the GF Data historic average of 1.3x EBITDA.

	Q4 2017	Q4 2016	Q3 2017	GF Data Historical Avg.
TEV/Ebitda	8.1	6.8	7.5	6.3
TEV/Ebitda % change		19.3%	7.0%	28.5%
Volume % change		19.3%	41.7%	
Quality Premium	127.1%	137.5%	106.1%	108.6%
Quality Premium % point change		-10.3%	21.1	18.5
Size Premium (TEV/Ebitda)	2.3x	1.9x	2.4x	1.3x
Size Premium % change		24.4%	-3.1%	73.3%

GF Data provides data on private equity-sponsored M&A transactions with enterprise values of \$10 to 250 million. GF Data gives private equity firms and other users more reliable external information to use in valuing and assessing M&A transactions.

- GF Data defines the Quality Premium to include better financial performers (businesses with TTM EBITDA margins and revenue growth rates both above 10 percent, or one above 12 percent and the other metric at least 8 percent. Outliers on the high side are also excluded.)
- GF Data defines the Size premium to compare transactions with \$10-50mm in TEV vs. completed deals with \$50-250 million in enterprise value