THE Effects of the Tax Cuts and Jobs Creation Act (TCJC) on Corporate Valuation

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New provisions of TCJC

- Corporate tax rate will be 21% regardless of taxable income
- Prior law-15% to 36%; 35% max effective tax rate
- Alternative minimum tax repealed

Effect on corporate valuation

- Generally positive
- Especially for public corporations
- 21% vs 35% tax rate
- No AMT
- Income under 50,000 is not helpful
- Under 50,000 = 15%
- 50-75K 25%
- 75-100K 34%
- Breakpoint= $90,385

continued

- Breakeven point= 90,385
- For smaller C corps TCJC may not be beneficial
- For large, publically traded companies- generally beneficial.
- S corp. vs C corp.
- S corp. rate-individual rate- 0 to 37%, plus a 20% maximum deduction
- Complicated- another separate issue

For publically traded companies

- Generally in 35 % bracket over 18M in taxable income
- If over 10M – rate is 34%
- New rate is 21 %
- Represents a 14% reduction to most publically traded corporations

Corporate valuation models

- Dividend Discount Model
- Price Earnings Ratio
- Free Cash Flow Model

Results to Publically Traded corporations

- A reduction in tax rate increases:
- Net Income
- Cash Flow
- Retained Earnings

DDM

- P=D1/K-G
- D1 will increase as there will be more cash/net income
- Growth can also increase companies may opt to keep dividends growth constant
- Thus retain more
- G=retention ratio times net income

Price Earnings ratio

- P/E ratio= Price of stock/earnings per share
- EPS will increase due to higher net income
- Due to lower tax rate
- Price of stock should increase

Free cash Flow

- FCF firm vs FCF eqity
- Either way FCF increases due to lower tax rate
- FCFf/ Weighted average K= Vf
- =kd/d+e + ke/d+e
- FVFe/ke=Ve
- FCF should increase

Cost of equity and cost of capital

- Ke=rf + equity premium
- =Beta (rm-rf)
- Kc=Kdebt+ K e
- K debt will become problematic as lower tax rate will increase
- Also-limit to 30% of EDITDA
- K debt=I (1-tr)
- Kd increase; kc

Result

- Cash Flow, Net Income will increase due to lower tax rate
- K capital will increase
- Unless company is significantly all debt financed , cash flow will outweigh Kc.
- Result-TCJC-increase corporate valuation

Hypothesis for paper extension

- Small corps less then 90Km income-lower valuation-seek possible S Corp status
- Large corps-publically traded-will greatly benefit
- For high debt companies=detrimental
- Will take sample and expand paper and test hypothesis

Questions

- Questions?
  Thank you
- Happy 2019