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• Alternative minimum tax repealed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
• 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

- $P = \frac{D1}{K-G}$
- $D1$ 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 equity
• 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

• $Ke = rf + \text{equity premium}$
• $= \beta (rm - rf)$
• $K_c = K_{\text{debt}} + K_e$
• $K_{\text{debt}}$ will become problematic as lower tax rate will increase
• Also-limit to 30% of EDITDA
• $K_{\text{debt}} = I (1 - tr)$
• $K_{\text{d}}$ increase; $K_c$
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 than 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