“The Impact of Recent Tax Reform on ESOP Valuation”

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Agenda

- Timeline of H.R. 1 (TCJA)
- Summary of Most Significant Changes With Respect to Valuation
- Impact on ESOP Valuation Analysis
- Impact on Equity Value
- Take Aways

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Timeline of H.R.1 (Tax Cuts & Jobs Act)

- **October 26, 2017** The House passes a budget blueprint clearing a path for tax overhaul. Included, is a change to a flat corporate tax rate of 20%.
- **November 2** The House releases the "Tax Cuts & Jobs Act".
- **November 9** The Senate releases its tax reform bill, which also contains similar changes to the House's version of the Act.
- **December 13** A compromise between the House and the Senate is reached, including the 21% corporate tax rate.
- **December 22, 2017** The Tax Cuts Reform and Jobs Act, H.R. 1 is signed by President Trump.
    - ***Most significant change to the U.S. tax code in 30 years***
    - Temporary and permanent changes to personal and corporate tax law.
    - Markets generally reacted positively from the prospect and ultimate passage of tax reform.

Summary of Significant Changes

Federal Corporate Tax Rate

- Rate decreases from 35% to 21% for C corporations
  - All companies for ESOP valuation purposes
- State and local tax deductibility retained for corporations

Deductibility of Interest Expense

- Limited to 30% of adjusted taxable income (ATI)
  - ATI = EBITDA 2018 to 2021
  - ATI = EBIT 2022 and beyond
- Applicable to companies with revenue above $25 million
- Disallowed interest expense may be carried forward

Capital Expenditure Deductibility (Depreciation)

- Fully expense property eligible for bonus depreciation
  - 100% deduction of qualified property until 2022
- Stepped down of percentages from 80% to 0% from 2023 to 2027

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Summary of Significant Changes

Net Operating Losses

- NOLs from years after 2017 can only offset up to 80% of taxable income, cannot be carried back, and can be carried forward
- NOLs from prior years can offset 100%, can be carried back two years, and are limited to 20 years

Repatriation of Foreign Earnings

- Tax on repatriation of foreign earnings held in cash and illiquid assets of 15.5% and 8%, respectively
- Payable over 8 years

Impact on ESOP Valuation Analysis

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Corporate Tax Rates

	Pre - H.R. 1		Post - H.R. 1	
Federal Tax Rate		35.0%		21.0%
State Tax Rate [a]	6.3%		6.5%	
Federal Tax Deduction	-2.2%		-1.4%	
Effective State Rate		4.1%		5.1%
Combined Tax Rate		**39.1%**		**26.1%**

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Impact on ESOP Valuation Analysis

Discounted Cash Flow Method

Corporate rate decreases from 35% to 21%

Tax rate impacts projected financial performance

Change in tax rate impacts tax-affected interest rate on Weighted Average Cost of Capital (“WACC")

Likely all companies will be impacted for valuation purposes

- 2017 by comparison to 2016
- Regardless of ESOP ownership structure (100% S Corps included)

Impact on ESOP Valuation Analysis

Weighted Average Cost of Capital

Beta Calculation

- Change in tax rates may impact of beta calculation
- Unlever betas at historical tax rates and actual capital structures
- Relever betas at new tax rate and assumed capital structure

After Tax Cost of Debt

- Tax deduction less because of lower tax rate
- Limited interest expense deductibility may impact WACC for highly leveraged companies

Slightly higher WACC rates may partially offset impact from lower tax rates in the DCF method.

Impact on ESOP Valuation Analysis

Weighted Average Cost of Capital (39.1% Tax Rate)

Required Return on Equity		
Capital Asset Pricing Model		
Risk-Free Rate of Return		2.6%
Market Equity Risk Premium	6.0%	
Selected Equity Beta	1.00	6.0%
Small Stock Risk Premium		5.6%
Company-Specific Risk Premium		0.0%
Required Return on Equity - CAPM		**14.2%**
Cost of Debt		
Cost of Debt		
Cost of Debt		6.0%
Less: Income Tax Factor	39.1%	-2.3%
After-tax Cost of Debt		**3.7%**
Weighted Average Cost of Capital		
Equity Allocation of Capital Structure	80.0%	11.4%
Debt Allocation of Capital Structure	20.0%	0.7%
Weighted Average Cost of Capital (Rounded)		**12.0%**

Weighted Average Cost of Capital (26.0% Tax Rate)

Required Return on Equity		
Capital Asset Pricing Model		
Risk-Free Rate of Return		2.6%
Market Equity Risk Premium	6.0%	
Selected Equity Beta	1.05	6.3%
Small Stock Risk Premium		5.6%
Company-Specific Risk Premium		0.0%
Required Return on Equity - CAPM		**14.5%**
Cost of Debt		
Cost of Debt		
Cost of Debt		6.0%
Less: Income Tax Factor	26.0%	-1.6%
After-tax Cost of Debt		**4.4%**
Weighted Average Cost of Capital		
Equity Allocation of Capital Structure	80.0%	11.6%
Debt Allocation of Capital Structure	20.0%	0.9%
Weighted Average Cost of Capital (Rounded)		**12.5%**

Impact on ESOP Valuation Analysis

Discounted Cash Flow Method (39.1% Tax Rate)

U.S. Dollars in Thousands

	For the Fiscal Year Ending					
	Year 1 12/31/2018	Year 2 12/31/2019	Year 3 12/31/2020	Year 4 12/31/2021	Year 5 12/31/2022	Residual
Distributable Cash Flows						
EBITDA	$ 2,000	$ 2,100	$ 2,205	$ 2,315	$ 2,431	$ 2,504
Depreciation and Amortization	(200)	(220)	(242)	(266)	(293)	(372)
Income Taxes @ 39.1%	(704)	(735)	(768)	(801)	(836)	(834)
Debt-Free Net Income	**1,096**	**1,145**	**1,195**	**1,248**	**1,302**	**1,298**
Depreciation and Amortization	200	220	242	266	293	370
Capital Expenditures	(200)	(250)	(300)	(350)	(400)	(400)
Additional Working Capital	(50)	(60)	(70)	(80)	(90)	(50)
Distributable Cash Flows	**1,046**	**1,055**	**1,067**	**1,084**	**1,105**	**1,218**
Present Value of Distributable Cash Flows						
Weighted Average Cost of Capital	12.0%	12.0%	12.0%	12.0%	12.0%	
Discount Period	0.50	1.50	2.50	3.50	4.50	
Present Value Factor	**0.9449**	**0.8437**	**0.7533**	**0.6726**	**0.6005**	
Present Value of Distributable Cash Flows	**989**	**890**	**804**	**729**	**664**	

Enterprise Value	
Total Present Value of Distributable Cash Flows (Through 2022)	4,100
Present Value of Residual Cash Flows	8,100
Enterprise Value, Controlling Interest Basis (Rounded)	**$ 12,200**

Residual Value	
Residual Cash Flow	$ 1,218
Weighted Average Cost of Capital	12.0%
Less: Residual Growth Rate	-3.0%
Capitalization Rate	**9.0%**
Residual Cash Flow Value	**13,538**
Present Value Factor	0.6005
Present Value of Residual Cash Flows	**$ 8,100**

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Impact on ESOP Valuation Analysis

Discounted Cash Flow Method (26.0% Tax Rate)

U.S. Dollars in Thousands

	For the Fiscal Year Ending					
	Year 1 12/31/2018	Year 2 12/31/2019	Year 3 12/31/2020	Year 4 12/31/2021	Year 5 12/31/2022	Residual
Distributable Cash Flows						
EBITDA	$ 2,000	$ 2,100	$ 2,205	$ 2,315	$ 2,431	$ 2,504
Depreciation and Amortization	(200)	(220)	(242)	(266)	(293)	(372)
Income Taxes @ 26.0%	(468)	(489)	(510)	(533)	(556)	(554)
Debt-Free Net Income	**1,332**	**1,391**	**1,453**	**1,516**	**1,582**	**1,578**
Depreciation and Amortization	200	220	242	266	293	370
Capital Expenditures	(200)	(250)	(300)	(350)	(400)	(400)
Additional Working Capital	(50)	(60)	(70)	(80)	(90)	(50)
Distributable Cash Flows	**1,282**	**1,301**	**1,325**	**1,352**	**1,385**	**1,498**
Present Value of Distributable Cash Flows						
Weighted Average Cost of Capital	12.5%	12.5%	12.5%	12.5%	12.5%	
Discount Period	0.50	1.50	2.50	3.50	4.50	
Present Value Factor	**0.9428**	**0.8381**	**0.7449**	**0.6622**	**0.5886**	
Present Value of Distributable Cash Flows	**1,209**	**1,090**	**987**	**896**	**815**	

Enterprise Value

Total Present Value of Distributable Cash Flows (Through 2022)	5,000
Present Value of Residual Cash Flows	9,300
Enterprise Value, Controlling Interest Basis (Rounded)	**$ 14,300**

Residual Value

Residual Cash Flow	$ 1,498
Weighted Average Cost of Capital	12.5%
Less: Residual Growth Rate	-3.0%
Capitalization Rate	**9.5%**
Residual Cash Flow Value	**15,766**
Present Value Factor	0.5886
Present Value of Residual Cash Flows	**$ 9,300**

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Impact on ESOP Valuation Analysis

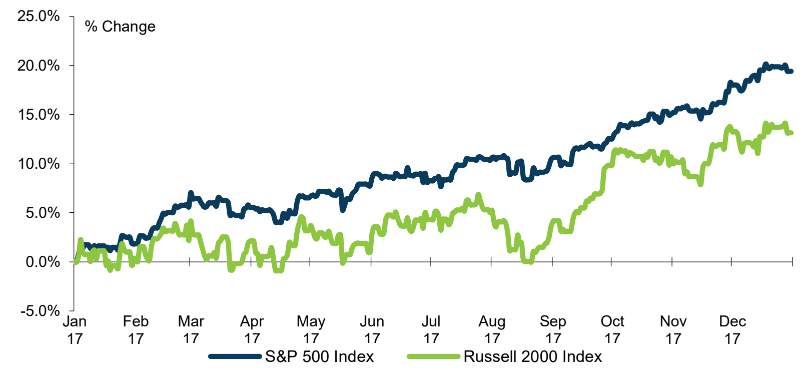
Public Market Multiples

Valuations in the public markets increased in 2017 (as far back as August of 2017) due to the Act.

- Prospect and ultimate passage of tax reform
- Multiples are generally higher in 2017 v. 2016

However, potential for disconnects in mid-year valuations between market (both private and public) and income approaches (for 2017 valuations).

One-Year Stock Index Performance



Source: S&P Capital IQ, Inc.

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Impact on ESOP Valuation Analysis

Private M&A Market Multiples

Pre-Act transactions will not reflect changes from the Act

- Tax rate and other expenditures

Adjustments to M&A data may be necessary for comparability

Tax Shield Calculations

Lower tax rates will lead to smaller adjustments for present value of tax shields and further offset impact from lower tax rates in the DCF approach

Impact on ESOP Valuation Analysis

Q2 2018 Deal-making environment is “healthy” in the middle market (MM).

IPO market is “hot” as of Q2 2018.

MM funds and deals are increasing in size while purchase price multiples remain elevated.

Reduction in corp tax rate will lead to an increase in FCF and EV for most PE portfolio companies as tax payments decrease.

- EV/EBITDA multiples are expected to increase.

Expected increase in asset acquisitions due to new capex rules due to certain new and used asset purchases to be expensed at 100%.

TCJA benefits capex intensive companies.

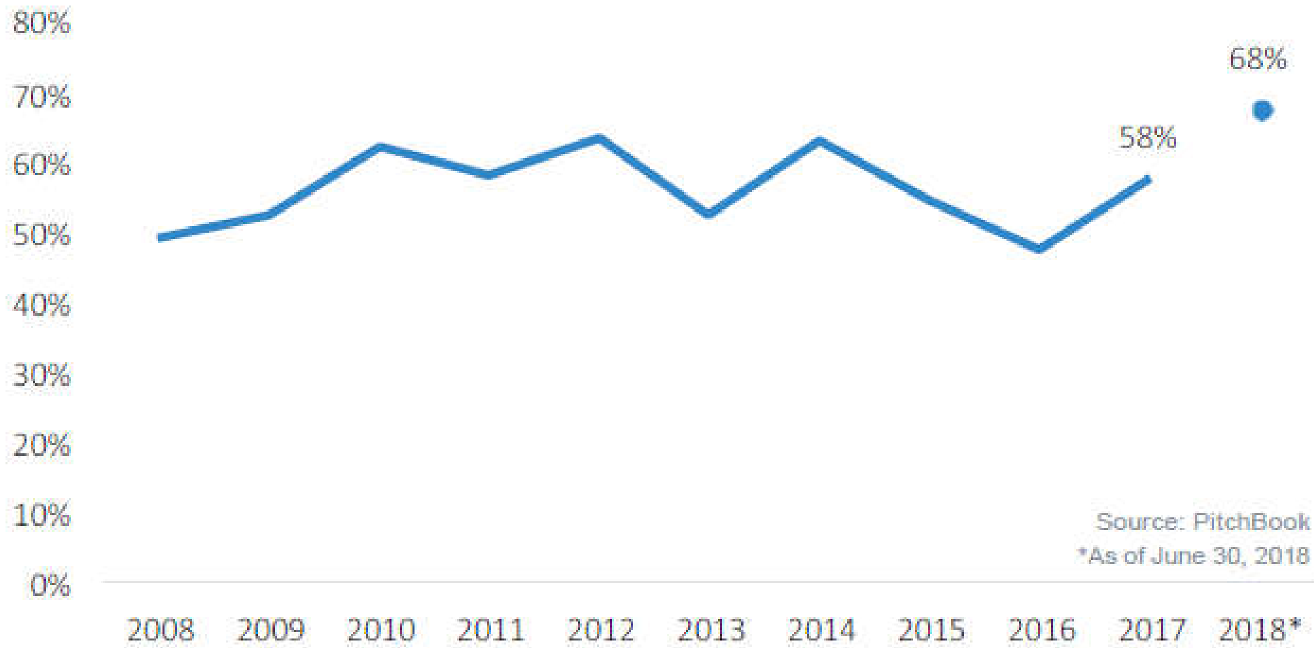
- However, benefits will only last 5 to 6 years due to interest deductibility, which is further reduced to 30% of EBIT in 2022 and bonus capex expensing trails off in 2023.

Source: Pitchbook 2Q 2018 US PE Middle Market Report

Impact on ESOP Valuation Analysis

MM Activity increases to highest proportion of PE deal flow in more than a decade

US PE MM deal value as proportion to all US PE



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Impact on Equity Value

Increase in Value per Share (all other things equal)

Average impact on Enterprise Value could be between 5-15% (all else being equal) depending on facts and circumstances

Repurchase Obligation

Decrease in tax rate may result in an increase in share value

For S Corporations, there is no actual corresponding increase in cash flow to cover an increase in repurchase obligation

May need to consider impact of discount for lack of marketability

C corporations will generally see a reduction in taxes and may have additional cash to fund increase in repurchase liability

Impact on Equity Value

S Corporation Shareholder Income Deduction

Partial ESOPs

Non-ESOP shareholders will have 20% less taxable income and 20% less in distributions

- ESOP will likewise have 20% less in distributions
  - Could slow the process of ESOP loan repayment if distributions used

However, less distributions could also mean greater retained cash in the company (may need to revisit amount of plan contribution)

Leveraged ESOPs & Interest Deductibility

Companies with $25+ million revenue

30% ATI = EBITDA, 2018 to 2021; EBIT, 30% 2022 and beyond

Real impact on C corporations and partial S corporation ESOPs

Could impact new leveraged ESOPs with large amounts of debt

- S corporation versus C corporation
- Tax deductible interest expense could be lower with higher taxable income

Take Aways

- Expect to see an increase in valuation (all other things equal) as a result of the tax law changes
- Examine capital expenditures and future needs over the projected period
- Pay attention to the WACC and influence of changes
- May be a good time to revisit repurchase obligation studies due to increase in value without a commensurate increase in actual cash flows for some plan sponsors
- Examine Adjusted Taxable Income (ATI) with respect to interest deductibility limits

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Erin D. Hollis, ASA, CDBV, is a Director at Marshall & Stevens Incorporated. She works within the financial practice group and with ESOP clients on financial analysis and consulting services needs.

Experience – Since 2000, Ms. Hollis has worked with advisors and closely-held business owners for valuation needs, and has experience providing valuation advisory and economic analysis services in the areas of litigation, taxation, transactional, and planning purposes. Erin has provided professional services in industries, such as manufacturing, construction, transportation, agricultural, distribution, retail, wholesale, and a wide range of service industries.

She is a qualified expert witness, and has testified for various marital and corporate litigation matters. She is a prolific author and speaker on the subject of business valuation, and has written for several industry trade publications and as a contributing author for professional organizations. Erin sits on the Business Valuation Committee of the American Society of Appraisers (ASA) and is a past ASA Chicago Chapter President. She is also a member of the Valuation Advisory Committee and the Interdisciplinary Advisory Committee on Fiduciary Issues of The ESOP Association and a member of the (NCEO) National Center for Employee Ownership, and has spoken at conferences on the topic of ESOPs.

Education – Erin received a B.A. and B.S. from Michigan State University. She is an Accredited Senior Appraiser (ASA) with the American Society of Appraisers, and Certified in Distressed Business Valuation (CDBV) with the Association of Insolvency & Restructuring Advisors (AIRA).