TAXES AND CORPORATE BONDS

Much of the focus on corporate tax reform has been around the headline 20%, and less around the details related to interest deduction, business expense, and various other pieces that are likely to change how companies look at their cash usage and capital structures. Below we explore the implications of the House and Senate bills on the credit markets. In our opinion, the potential changes to corporate taxation are yet another reason to reassess high yield corporate bond positions and consider ways to move up the ratings spectrum.

By Jody Lurie, CFA, Director, Corporate Credit Analyst

- Positives of the new corporate tax plans include a lower corporate tax rate (20% vs the current 35%), business expense deduction, and corporate cash repatriation. Negatives include limitations to interest deductions and modifications to research & development credits. Apart from the tax rate, there is notable concentration in the companies that will realize the benefits in corporate taxation vs those that will see offsetting effects of the pros and cons.

For corporations, much of the discussion around the House and Senate’s tax plans has centered on the fall in the corporate tax rate to 20% from 35%. As the two sides of Congress try to resolve discrepancies in the two plans and address the potential cost of the tax changes, newswires (and some lawmakers in Washington) have reported that a 22% rate is a potential alternative to the initially proposed 20% rate. (Note that for pass-through entities and special types of corporations, the proposed rate is not 20%.) Nonetheless, the over 400-page documents contain much more than just a simple cut to the corporate rate. In fact, in the case of corporate bonds, other parts of the plans are notable, though less discussed due to the likelihood that such provisions will change from their current forms. Thinking about effects of the current plans on the corporate bond market is beneficial for portfolio repositioning.

Treating Debt Differently

- The concentration of firms that will benefit from the lower cost to repatriate foreign earnings vs the current system is meaningful, and a lower cost by itself is not likely to alter managements’ behavior.

Cash repatriation is a main selling point coming from both the House and Senate tax bills. As our colleagues noted in Tax Plan Proposal and Investment Implications, the final tax rate for corporations in bringing their foreign earnings to the US is 14%. The influx of cash held overseas can be used for various measures, including capex, mergers & acquisitions, share buybacks, dividends, and debt repayment, among other possible uses. By itself, corporate cash repatriation does not necessarily translate to a positive for bondholders, but it does imply that firms which previously used the debt markets to finance various cash usage activities may be persuaded to look at their own balance sheets. Still the difference in the currently low cost of debt capital—average yield, as of writing, for investment grade bonds is 3.24% and for high yield is 5.66%—and the 14% one-time rate may not dissuade firms from utilizing the debt markets as they have done over the past few years, seen through record issuance. Nonetheless, other portions of the bill, as discussed below, are there to steer firms to specific behavior: by that we mean business spending and reduced debt issuance.

### Interest Deduction

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<th>House Language</th>
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<td>In the case of any taxpayer for any taxable year, the amount allowed as a deduction under this chapter for business interest shall not exceed the sum of—(A) the business interest income of such taxpayer for such taxable year, plus (B) 30 percent of the adjusted taxable income of such taxpayer for such taxable year. The amount determined under subparagraph (B) (after any increases in such amount under paragraph (3)(A)(iii)) shall not be less than zero.</td>
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Source: Janney ISG; House bill as of 11/2/2017; Senate bill as of 12/2/2017; Cornerstone; Bloomberg

SEE PAGE 3 FOR IMPORTANT INFORMATION REGARDING CERTIFICATIONS, OUR RATINGS SYSTEM, AS WELL AS OTHER DISCLAIMERS
Expensing Business Expense

- Tax reform should, in theory, encourage additional capex. Those firms that have cash trapped overseas will continue to weigh capex against alternative uses of cash, while only a subset of those that need to access the capital markets to finance business expense will be penalized for relying too heavily on the debt markets.

In both the House and Senate versions, the new tax system would allow for 100% business expense through the next few years (2022 through 2024, depending which version, what type of asset, etc.). This immediate deduction is in response to the question of how companies would spend their cash once they repatriate it, offering an alternative to shareholder remunerations. At the same time, combined with the interest deduction limitations, the repatriated cash in theory should go towards debt repayment, as the value of taking on additional debt deteriorates. Interestingly, the overlap of companies with large cash balances held overseas and companies that may hit the interest deduction limitations discussed below is fairly slim, so companies that do repatriate cash may not look for early debt repayment, but rather an alternative use of cash. Whether organic capex will be the solution or whether firms will look at more generous dividend policies, despite still seeing double taxation (one at the corporate and one at the shareholder level), remains to be seen. It is likely that the new reform will tip the balance for firms on the fence about multi-year capex over a complete change in behavior; companies not favoring capex will not arbitrarily spend to get the tax benefits.

Capping Interest Deductions

- Not every high yield company will see the negative effects of an interest deduction cap that will partially offset the lower corporate tax rate.

Only as the Senate neared the minimum number of votes for its version did the Street begin to look at interest deduction changes, a tax reform issue we discussed in our daily publication. The potential changes in treatment of interest deduction in the House and Senate versions are outlined above and do not affect every corporation with debt, and therefore interest, outstanding. In fact, those highly leveraged, high yield rated credits will see most of the negative impact brought on by limitations to interest deductions. Further, the companies that have an outsized amount of debt on hand to trigger the interest deduction cap are also those that operate with thinner margins, thereby experiencing an offset for some or all of the benefit of a lower corporate tax rate. Of note is the difference between the House and Senate versions, with the House providing more leniency in terms of the deduction cap over the Senate, as illustrated to the right. For the firms with the largest weighting in the Bloomberg/Barclays High Yield index, not all will experience negative effects of the proposal, and many of the firms that will, are in certain sectors, such as telecom/media. Further, companies that were takeover targets of private equity firms tend to be those that will experience elevated costs from a lack of full interest deduction. How these firms restructure their capital structures will be a lingering question for management teams of companies with weaker credit profiles.
Market Reaction to Tax Reform and Investors’ Next Steps

- Tax reform by itself is unlikely to be the impetus for a selloff in corporate bonds, but it contributes to the reasons for investors to reassess their high yield corporate bond positions and opt for higher quality credits.

Even though we are moving closer to a potential plan that has some sort of interest deduction cap, the markets have not reacted as expected. In fact, corporate bonds have rallied with other risk assets, as high grade corporates will see more advantages than disadvantages and as the story is mixed for high yield corporate bonds. Further, low-rate market dynamics have kept investors hunting for yield, even at the precipice of sizable changes to corporate capital structures, given the expected probability of a tax bill in its current form(s) passing. Further, the reduced corporate tax rate will offset negative effects of interest deduction limitations, but the firms mostly affected by the latter will not have the same flexibility as their high grade counterparts to participate in the business expense deductions. Many high yield credits that fall in this classification will not benefit from the corporate cash repatriation, as their operations are largely domestic.

Just a few weeks ago, high yield corporate credit spreads widened in part from the potential negative effects of the tax bill. Although they have since moderated, should a bill that contains some form of the provisions above pass, the markets may take a closer look at those firms who will not stand to gain as much as the few at the top. These large-scale changes add to the pressures that already exist in this tight credit spread environment that we already view as overbought. Moving up the ratings spectrum now and being more selective in investment decisions is already prudent behavior, regardless of how Washington decides to alter corporate taxes. In a market that is perceived to have decreased liquidity during volatile times, investors would benefit from reassessing portfolios and exiting positions that are less able to absorb the additional costs of an interest deduction cap. We do not see tax reform as the catalyst it is expected to be, but we also do not see it alone as the main cause of a massive rotation out of high yield corporates. We do, however, suggest caution in light of the lopsided benefits for higher rated over lower rated firms.

For additional comments on the corporate bond market, please see High Yield Sector Showing Signs of Frothiness Recently and A Credit Perspective: How the Next Downturn Will Be Different.