Seer Capital Management LP
1177 Avenue of the Americas, 34th Floor
New York, NY 10036
(212) 850-9000
www.seercap.com

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**The Tax Cut & Jobs Act and Securitized Products;**
**Winners Should Far Outnumber Losers**
**February 2018, Karen Weaver, Seer Capital**

## Overview

Tax reform is expected to be a modest positive for the US economy overall, and for Securitized Products as well. For Commercial Real Estate, the reform provisions are supportive, though not as dramatic as corporate tax rate changes, and more a case of retaining existing, favorable tax treatment for CRE investment. In credit, tax reform is a net positive, though more so for Investment Grade credits than High Yield, and more in the short run than long run. For the housing market, the tax code changes are negative, but in the context of very strong positive momentum and solid fundamentals, reform probably prevents overheating of the housing market more than anything else. The one pocket most clearly negatively impacted by tax reform is redundant to high-value homes in high-tax jurisdictions. These homes are a small subset of Securitized Products collateral. Further, the negative credit impact for this niche of homeowners is unlikely to be material enough to impact their ability to service their debts, or significantly curtail their spending. However, we may well see home prices stall for this niche. As always, aggregated impacts are less useful in assessing risk than granular loan-by-loan analysis, and there will be some net losers under tax reform (though we expect there to be few). Many analysts believe that the secondary impacts of the Tax Cuts & Jobs Act ("TCJA") on financial policy will prove more important than tax reform itself.

## The Economy

Tax reform has already led to a big jump in 2018 earnings estimates, and should provide a boost to corporate America, especially given the market's supposition that central banks will move slowly and cautiously to normalize monetary policy. It remains to be seen how much of the tax cuts are funneled into business investment and/or increased wages, versus share buybacks, M&A and deleveraging, and hence the extent to which corporate tax cuts will increase growth. The promised "tax holiday" for offshore funds could provide an incentive to repatriate $2.5 to $3.0 trillion, which could also be stimulative to the extent it is used to expand operations. While tax cuts for households will be stimulative, it is estimated that over three-fourths of the personal tax cuts will flow to those earning more than $200,000 (the top 5%), who are less likely to spend on current consumption than other income groups. Street forecasts are for GDP growth of 2-2.5%, with upside potential. Moody's estimates that the tax cuts will add one-tenth to two-tenths of a percent to GDP, while others have estimated that reform might add as much as 0.6% to GDP growth. Generally lower tax obligations will enhance debt service capacity for corporations and households; however, there will be credit-negative tax increases on a subset of obligors (again, a small subset).

At the state level, one can expect increasing resistance to local tax increases as taxpayers lose a significant portion of state and local tax deductions, aka "SALT". Taxpayers negatively impacted to a material extent by curtailment of SALT deductions might also reduce discretionary spending, shrinking state sales-tax revenue (the source of 40% of state revenues on average). Other impacts of reform might offset this.

While consensus (and the markets) view tax reform as a shot of adrenaline for an already strong economy, there are some possible downsides, of course. Because tax receipts will be reduced (Moody's estimates the tax cuts will cost ~1% of GDP on average for the next 10 years), federal deficits may grow faster than previously expected if growth is insufficient to offset lower tax rates. Higher government borrowing needs would then coincide with the Fed's plans to normalize interest rates and stop asset purchases. This would increase borrowing costs, all else equal. There is also the possibility that tax reform succeeds "too well", overheating an economy already at full employment. This would fuel inflation pressures and speed up monetary tightening. Lastly, we are now nine years into recovery and hence at a stage when the economy should not need stimulus. By using fiscal stimulus at this juncture, we reduce the options in the policy toolbox in the next recession, perhaps exacerbating the next downturn.

**Impact on Commercial Real Estate/CMBS**

Consensus at a recent CRE industry conference was positive for 2018, in part because many see tax reform as bullish for CRE. Several participants expressed the view that the stimulus package could extend the cycle in CRE for another 3-5 years. Expected rent growth fuels this view, in particular for multifamily (as the rent vs. buy equation shifts more toward renting) and for retail (benefitting from a strong consumer). Rising interest rates and the transmission into cap rates are widely viewed as manageable. A recent study from Standard and Poor's showed that cap rates are not as highly correlated to Treasuries as supposed, especially when rates are relatively low.

While the biggest impact of tax reform for CRE is expected to come from the expected boost to GDP, a reduction in taxation for pass-through income is also a positive for the sector. Moreover, highly favorable depreciation of capex also makes it cheaper for CRE investors to retrofit and reposition property. Apart from these factors, CRE benefitted as much from a *lack of tax reform* as anything else. That is, some tax provisions that tend to favor CRE had been on the chopping block but ended up being preserved in the final bill.

- For example, the tax code allows **"Like Kind Exchanges"**, by which investors can defer capital gains on the sale of a property by reinvesting proceeds into another qualifying "like-kind" property. One key change in the new tax bill is that a Like Kind Exchange can only be used to defer capital gains on the value of *real* property and not personal property (from equipment and fleets to artwork and fixtures).
- There had also been debate about continuing to allow **"Carried Interests"** to be taxed at lower capital gains rates rather than ordinary income rates. After some wrangling, the final bill kept the favorable treatment for Carried Interests, but increased the minimum holding period requirement from one year to three. Most real estate investors hold property for three years or more in any event. The change could, however, increase tax liabilities for "fix-and-flip" property investors.
- Lastly, **depreciation rules for real property and improvements were unchanged**. At one juncture it was proposed that CRE deprecation be accelerated from 39 years down to 25. While that would have been a bonus for CRE, the experience of The Economic Recovery Tax Act of 1981, which greatly sped up CRE depreciation, shows that faster depreciation provided "too much" of an incentive to invest in real estate development projects and led to an overbuilding boom--and eventual bust.
- One of the most attractive elements of the recent tax reform is the **treatment of "Pass-through income".** The change impacts individuals and family trusts investing in real estate through partnership entities, such as LLPs and private equity funds, and REIT investors. Owners of a pass-through entity report the business's income on his or her individual tax return. Under the new tax law, they may now claim up to a 20% deduction. For example, if an LLP owns a property that generates $100,000 in income to its investor partners, those investors could avoid paying taxes on as much as $20,000. While the stated intent behind this tax provisions is to create jobs (by count, nearly 95% of US businesses are structured as pass-through entities, and most all small businesses are), the provision also allows real estate investors to benefit from the deduction. As a result, the changes in the tax code might usher in changes in ownerships structures for CRE. Though business owners in a pass-through entity will see their tax rate drop from 39.6% to 29.6% (i.e. the new top rate of 37% x (100% less the new 20% deduction), the corporate tax rate will

also drop significantly--from 35% to 21%. This begs the question: should taxpayers form a corporation rather than a partnership? The answer will depend on other factors, such as how their cash flow is treated, how frequently cash is pulled out, and the arcane particulars of the new tax laws that must be met in order to get the full 20% deduction. Lastly, many of the new tax provisions are not permanent and will expire in ten years if not extended by Congress, and any shift in power in Congress could even spark a roll-back. In any event, the pass-through income deduction does improve the economics for many CRE investors and creates incremental demand.

- Interestingly, new limitations on the deductibility of interest on corporate debt may have an unintended consequence. Going forward, **corporations may be more inclined to own their real estate**, as mortgage debt remains fully deductible whereas corporate debt now has limitations on deductibility. This could also create incremental demand for CRE.

**Impact on Residential Real Estate/RMBS**

Tax reform was not kind to the housing market, but housing is currently so robust that these changes are not likely to lead to significant negative consequences for the market as a whole. The tax reform act includes four provisions that negatively impact the tax advantages of homeownership, while at the same time reducing income taxes more broadly for many.

1. A near doubling of the **standard deduction**, which for the average household (e.g. making $50,000/yr.) would make it less attractive to itemize deductions and thus reduce the attraction of the mortgage interest deduction. These borrowers may be more likely to rent going forward. This could be a negative for new home construction, which has never recovered to normal levels and has already been far less of a contributor to the broad economy than in typical recoveries.
2. A reduction in the **Mortgage Interest Deduction (MID) cap** from $1mn of indebtedness down to $750,000 of indebtedness (with grandfathering). This will have a modest negative impact on an affordability for a small subset of high-value potential homebuyers in the higher price tiers.
3. New limits of the **interest deduction for home equity loans**, including any existing loans/lines (i.e. without grandfathering). In late February, the Internal Revenue Service clarified this point. From 2018 to 2026, interest is tax deductible on home equity loans if (and only if) it is used to "buy, build, or substantially improve the taxpayer's home that secures the loan." Until this year, borrowers were *also* allowed to deduct interest on up to $100,000 in HELs and HELOCs, regardless of the use of proceeds.
4. A new cap on the *aggregate* deduction for all state and local sales, income, and property taxes **("SALT"),** of $10,000. State and local taxes paid in 2015 (the most recent available) totaled $1.5 trillion, and $550bn of that was deducted from individuals' income taxes. Nationwide, 30% of taxpayers take SALT deductions; in states like NY, NJ and CT, the statewide average is 40%. New York state's average SALT deduction amount is the highest in the nation, at $22,000. In Westchester county 73% of residents pay at least $10,000 in property taxes alone, on top of high state and local tax burdens. While the vast majority of taxpayers will not be affected, in certain price tiers in a handful of markets, this change in the tax code could prove to be a material negative for home price appreciation.
5. It is also worth noting that the **individual tax cuts are not permanent but will expire at the end of 2025**. Because the tax reform bill did not include enough sources of revenue to offset its $1.5 trillion cost, Congress was unable to make most of the individual tax cuts permanent. The path of least resistance would be to allow the individual tax cuts to expire, with a net result that many individual tax payers will be worse off in 2026.

While these changes to the tax code are clearly negative for home prices as a matter of simple mathematics, it is not widely expected that tax reform will be particularly harmful to the broad housing market, for a number of reasons. Chief among those reasons is the context of these changes, i.e. a very robust housing market. Home prices have risen for 68 consecutive months, and momentum is strong, with the rate of appreciation accelerating. Affordability is solid, confidence is high, and inventories are very low. Nationwide, inventory is at 3.2 months, a record low and about half what is considered “normal” in a stable market. Household formations are high, and homeownership increased 2% YOY last quarter, the highest rate of growth in 13 years. Unemployment is low, wage growth is picking up, and mortgage lending continues to ease. The prospect for a pick up in inflation also incents homebuyers to jump in sooner. With all of these positives, and given the fact that the magnitude of the new tax provisions is modest for all but a small subset of homeowners, it seems unlikely that the TCJA would lead to a significant, nationwide home price decline. A recent Moody’s Analytics study looked at 20 housing markets they believe could suffer price erosion due to tax reform. Post-crisis prime RMBS transactions had an average exposure of ~3.4% to those markets, while Fannie Mae and Freddie Mac credit-risk transfer RMBS had an average exposure of 2.1%; clearly this is a niche issue.

Among street analysts, the expectation is that tax reform shaves perhaps 1% off of next year’s HPA, moderating from ~5% to ~4%; of course higher mortgage rates will also come in to play. Moody’s Analytics is considerably more bearish, suggesting that tax reform would reduce HPA by 4% nationwide over the next year. Most obligors will be in a slightly better position to meet their financial obligations post-tax reform. For those niche households that are materially negatively impacted by housing-related tax-reform, other aspects of the act may well be a net positive for them. Of course, that may ameliorate the impact of any given borrower’s financials, but it does not soften the blow to home prices in high-value-high-tax areas, which will simply become less economical to own.

At their core, these tax changes alter the economics of home owning for many. The actual reduction in homeownership incentives depends on the level of income, marginal rates, mortgage interest, property taxes, family size and the standard deduction. An analysis by the Urban Institute estimated breakeven annual rent for four groups of hypothetical borrowers, with incomes of $50K, $75K, $150K and $300K. For the lowest income example, the change in the tax code did not impact the rent vs. buy equation. However, for the highest income borrower, a $300,000 income household buying a $1.2mn home, annual breakeven rent went from $33,086 under 2017 tax law, up to $43,570 under current law, a 32% jump. This augurs well for luxury multifamily and poorly for the value of high-end homes. While prominent housing economists such as Robert Shiller will argue that homebuyers are irrational and react slowly to policy, the magnitude of these figures for the top of the market is hard to dismiss. It is true that many factors influence the traditional preference for buying, including upside potential, inflation hedging, forced savings, better selection of housing stock for purchase than for rent, and the availability of leverage on good terms. However, none of these factors are new; what is new is less favorable tax treatment for homeowners.

As it relates to Securitized Products, again, most of the underlying housing stock will only be marginally impacted if at all. For example, of 382 MSAs, there are only 26 where high value homes (defined here as >= $750K) make up even 10% of the market. Those are areas that might be impacted by the new cap on MIDs. There are only 19 counties (of 3142) where average property taxes exceed $10,000. Not surprisingly they are mostly in the NYC Metro, New York and New Jersey; southern Florida; coastal California; and, to a lesser extent, Chicago and Texas.

The change in the MID cap impact is fairly easy to measure. If we assume the worst case, i.e. a household with a mortgage of >=$1 million moves houses and becomes subject to the new $750k indebtedness cap, they lose the ability to deduct interest on $250,000 of their mortgage debt. Using current rates, that would be a ~$10,000 deduction. Assuming a marginal tax rate of 30%, this borrower would take a $3,000 after-tax income hit in year one of the mortgage. This is not particularly onerous given the level of income needed to qualify for a $1mm mortgage. Notably, home purchase above $750,000 are only about 7% of all transactions. Moreover, at these price points buyers are less likely to use financing than the median buyer. Because the MID is grandfathered, one of the more important impacts may be on mobility, with some high-end borrowers less willing to sell because it would reduce the subsequent deductibility of their mortgage interest. This could be one silver lining for higher value homes, if it limits the supply of existing homes for sale (all else equal, this would be constructive for home prices). On the other hand, some higher – value owners may choose to sell due to the curtailment of the SALT deductions.

It is also worth noting that, even where tax reform is negative for housing, the net impact of all the tax reforms may be positive for the household. For example, one street firm estimated that changes in housing-related tax policies could reduce income for jumbo borrowers in California and New York by 3 to 5%. However, the same firm noted that, in many cases, favorable changes to the Alternative Minimum Tax (AMT) will more than offset the loss of MID and SALT deductions. In addition, many high-income households will benefit from the cuts to corporate and individual income tax rates, and reduced taxes on partnerships. Although the personal income tax analysis is complex and requires a number of simplifying assumptions, one research group summed it up succinctly. Generally, households earning 50-85K will benefit from the higher child tax credit, households in the 100-200K income bucket will get hurt by the SALT and MID caps, while those households earning >200K will benefit from the higher AMT exemption.

The “AMT” or “Alternative Minimum Tax” is a mandatory alternative to standard income tax, triggered when a taxpayer’s income exceeds a stipulated level. AMT eliminates many deductions a taxpayer would otherwise take, but for hitting the AMT threshold income. AMT was intended to prevent high income earners from utilizing very high deductions to pay little or no income taxes. Essentially taxpayers calculate taxes twice, once for “regular” income tax, and once for the AMT—and then pay the higher amount. AMT means that taxpayers are not getting the full benefit of their deductions.

The new tax law raises the AMT standard exemption from $84,500 to $109,400 for joint return filers. That exemption phases out at higher income levels. The phase-out started at $160,900 under old tax law, but under the new bill the phase-out starts at $1,000,000. So, while tax reform cut MID and SALT deductions, in fact those deductions had always been somewhat illusory for many taxpayers due to the AMT. By reducing MID and SALT deductions while also making the AMT less onerous, the tax act has taken away with one hand, and given back with the other. The more generous AMT rules reduce taxes and so somewhat salve the wounds for the taxpayers who are losing some of their SALT deductions. But a lower AMT does *not* change the fact that these shifts in the taxation paradigm make high-value-high-tax housing a significantly less attractive investment and hence make it vulnerable to price declines, all else equal.

Which housing markets, specifically, appear most vulnerable? Moody’s Analytics projected that the impact of the new tax code in Manhattan could reduce home price appreciation there by as much as 10% over the next 18 months. Already we have seen a slowdown in activity, with the pace of sales down 12% YOY in Manhattan, arguably reflecting a disagreement between buyers and sellers about home values in the new tax regime. Since the change in SALT deductions is the most significant reform, those areas with the highest average SALT deductions are most vulnerable to softening (see below). It remains to be seen whether any softening will be confined to the higher price tiers, or whether it will have a “trickle down” effect on lower-priced homes as well. Moreover, these counties may come up against a stronger anti-tax sentiment going forward, possibly jeopardizing the very amenities (like schools) that drove the high property valuations in the first place, and also reducing their flexibility to back-fill any federal government cutbacks. Lastly, by widening tax rate disparities among states and metro areas, these tax reforms may make it harder for high-tax regions to attract businesses and hence lower their potential growth trajectory.

**Top Ten Counties for State and Local Tax Deductions 2014***

| | |
|---|---|
| New York County, NY | $24,898 |
| Marin County, CA | $16,956 |
| San Mateo County, CA | $15,405 |
| Westchester County, NY | $14,784 |
| Fairfield County, CT | $14,262 |
| Santa Clara County, CA | $12,562 |
| San Francisco County, CA | $12,116 |
| Nassau County, NY | $11,624 |
| Morris County, NJ | $11,440 |
| Somerset County, NJ | $11,267 |

** Source: IRS Tax Stats – County Data*

One analyst suggests that, within the subset of high-value-high-tax housing markets, of particular concern are markets where homeowners have a long tenure in their current homes. These homeowners may be on the verge of downsizing, and the increased after-tax SALT burden might expedite that process. Moreover, because of that long tenure in their homes, they may have very large paper gains and be more willing than recent buyers (with smaller or no gains) to sell "below market" in order to reduce their property tax burden. If we choose the year 2000 as a cutoff, 27% of US homeowners moved into their current home before 2000. In one NYC metro market, that figure is 45% (see below). This might suggest a unique vulnerability. However, all of the aforementioned strengths of the housing market are possible offsets to these headwinds. High-value-high-tax markets have some unique factors that are supportive as well; e.g. rapid job growth in CA markets, a strong bonus season in the NY metro, and in both markets, a significant cohort of investors with stock market exposure, who may prefer investing in real estate at this juncture.

**Counties Surrounding NYC***

| County | % Moved in < 2000 | % Valued Above $500k | HPA Since 2000 |
|---|---|---|---|
| New York County, NY | 45% | 43% | 70% |
| Marin County, CA | 35% | 52% | 59% |
| San Mateo County, CA | 34% | 43% | 61% |
| Westchester County, NY | 35% | 39% | 50% |
| Fairfield County, CT | 39% | 35% | 55% |
| Santa Clara County, CA | 32% | 39% | 52% |
| San Francisco County, CA | 31% | 41% | 32% |
| Nassau County, NY | 41% | 31% | 35% |
| Morris County, NJ | 34% | 35% | 67% |
| Somerset County, NJ | 41% | 26% | 65% |

** Source: US Census Bureau, FHFA, Morgan Stanley Research*

At the end of the day, there are three things that will determine how tax reform impacts the housing market.

1. First, what is the **net impact on after-tax income and hence affordability**? The answer is, generally positive. But there are some important caveats. In markets like coastal California, where a lot of households are in the 100-200K income bracket, they are likely be net losers from tax reform.
2. Tax reform has **increased the relative attractiveness of renting vs. buying**. All else equal that should reduce demand and hence reduce the equilibrium price of housing.
3. **How well understood is the impact of tax reform, and is the tax paradigm expected to remain static**? Under the old tax law, for example, SALT deductions were fully deductible without limitation. However, as discussed above, for many higher income borrowers, those SALT deductions (as well as other deductions) were often illusory after taking into account the AMT. For anyone impacted by AMT, their SALT deductions were already curtailed under the old tax code, even if that was not clear because it was not expressly stated as such but effectuated through AMT. It is unclear how many buyers truly know (or will much care) exactly how tax reform has impacted their cost of ownership.

**Impact in Leveraged Loans/CLOs**

The tax reform act is generally positive for corporate credit. Corporate borrowers should benefit from the act's stimulative impact on the broad economy and, for the vast majority, lower tax bills. TCJA also provides incentives for corporations to de-lever, which could reduce debt supply (providing a positive technical). The greatest beneficiaries of reform will be investment-grade issuers and cross-over credits, however, who are more likely to use incremental cash flow for dividends and buybacks, capital investment, and M&A than for debt reduction. For those companies which are negatively affected by tax reform, we may see adjustments in their capital structure and de-leveraging. But while the new tax code increases the after-tax cost of debt, we expect adjustments will be largely on the margin. Debt will remain an attractive form of capital, even with less favorable deductibility.

While undeniably bullish for the credit sector in aggregate, tax reform will not benefit all companies equally. The impact of the changes will depend on the borrower's effective tax rate under the old tax law, the nature of the industry in which it competes (especially as it relates to capital spending requirements), and the extent of any overseas operations. On the "con" side of the ledger, there is some concern that tax reform may prove inflationary and lead to tighter monetary policy. There is also concern that, over the long run, the new cap on interest deductibility will be pro-cyclical (that is, could make any future downturn worse). Lastly, some argue that fiscal stimulus like tax cuts should have been "saved" to use if and when the economy enters a recession, and that we may have squandered a valuable tool that could have helped soften a future downturn.

There are four key elements to corporate tax reform. Two are designed to be stimulative, one is designed to reduce corporate leverage, and one is designed to increase tax revenues. They are:

1. The most dramatic change is a permanent reduction in the **corporate statutory tax rates**, to 21% from 35%. Unlike many other provisions of the new code, this does not sunset.
2. The TCJA also provides full, upfront **depreciation of capital expenditures**, a further break for corporations. Starting in 2018, one-hundred percent of capex investments can be deducted in the year incurred (with that perk scaling back in 2023 to 80% deduction in year one and in 2024 to 60%, and so on). The more capital-intensive sectors (autos, telecommunications, utilities), definitionally, will benefit most from this provision.

3. and 4. Less favorably, corporate tax reform also includes **caps on deductions for interest expense** and **caps on the use of net operating losses (NOL's).** For the first three years interest deductions will be capped at 30% of EBITDA. In 2022, the interest expense deduction is scaled back further, as the cap switches from 30% of *EBITDA* to 30% of *EBIT*. In addition, NOLs will be limited to 80% of taxable income. NOL carrybacks are no longer allowed, but carry forwards, which had been limited to 20 years, can now be carried forward indefinitely.

By reason, those sectors with high effective tax rates today have the most to gain from the dramatic reduction in the statutory rate. But most borrowers won't truly receive the full, headline 14-percentage-point drop in corporate tax rates. According to the Treasury Department's Office of Tax Policy, after various deductions and deferrals the average effective corporate tax rate in 2014 (the latest available) was 24%— far closer to the new 21% rate than the old nominal rate of 35%. Keep in mind, as well, that the value of any deductions going forward will also be lower with a lower statutory rate in place. That said, net-net, corporations are still clearly significant beneficiaries of tax reform via both lower tax rates and the immediate expensing of capital expenditures.

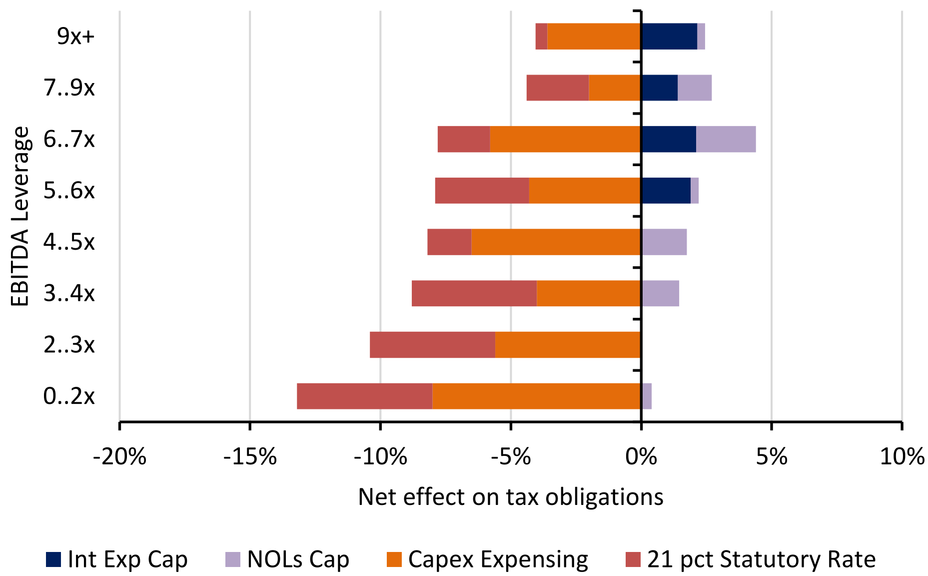
Limits on the deductibility of interest expense are a headwind for some borrowers in Leveraged Loans and High Yield, but this may be less detrimental than it seems. Many highly leveraged issuers—especially leveraged buyouts, which currently make up nearly half of Leveraged Loan volumes— will not have tax obligations in any event. Other issuers, such as in the Oil and Gas sector, for example, have accrued extensive net operating losses (NOLs) after the last several years of difficult conditions in that industry. Some estimate that a full 30% of speculative-grade issuers don't pay taxes at all and will not under the new tax law as well.

That said, clearly some Leveraged Loan borrowers are likely to incur higher taxes due to the new limits on interest deductibility. The positive effects of tax reform are greater for investment-grade borrowers (those rated 'BBB-' and higher) than for speculative-grade ones ('BB+' and lower). Collateralized loan obligations (CLOs) are backed primarily by Leveraged Loans, and more than half of CLOs issued since 2010 have obligors with weighted average ratings of B2. Moreover, CLO obligors also tend to be less concentrated in those capital-intensive industries that will benefit from full capex deductibility. Across sectors, domestic manufacturing and services industries such as capital goods and energy are expected to see stronger benefits, as are those with relatively large labor components such as restaurants, retail, and food producers. Sectors with the lowest estimated gain (i.e. smallest decrease in tax obligation as a percent of EBITDA) are telecoms, professional services, and transportation.

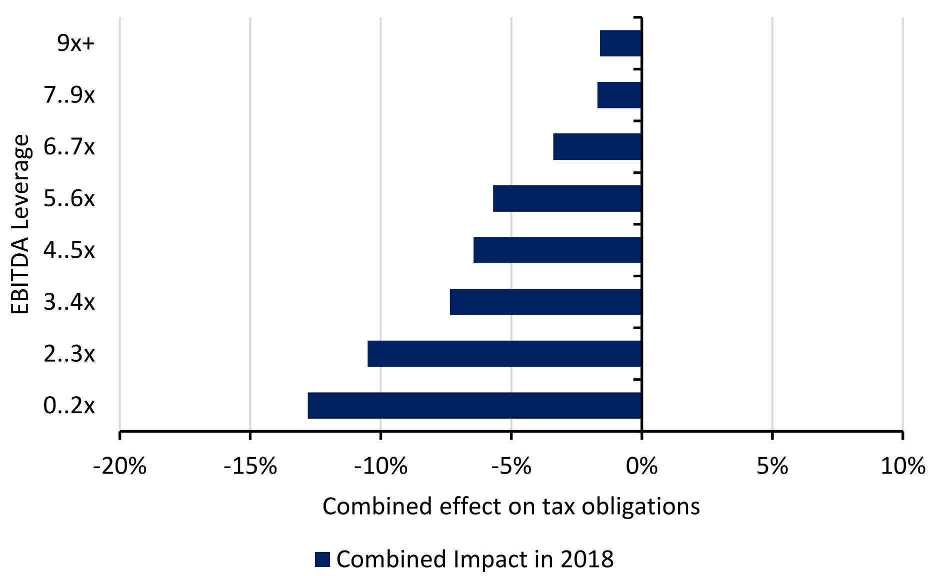
Even so, a recent analysis of speculative grade credit shows that the cash flow benefits of tax reform are expected to outweigh the downsides. The analysis showed that the detrimental effect from smaller interest and NOL deductions is modest compared to the benefits from capex expensing and lower statutory rates. For example, in 2018, HY issuers will face an incremental $1.3bn tax obligation from interest caps and $2.3bn from NOL caps, but that will be more than offset by reductions in tax obligations totaling $13bn from capex expensing and $10.5bn from the statutory rate reduction. The impact by leverage cohort favors less levered credits, although it is still positive for all cohorts. It was estimated that companies levered 6x or less (6x is the average leverage for the LevLoan sector) will realize a consistently strong net benefit ranging between 8-11% of their current EBITDA. The first figure below shows how the various components of tax reform impact each cohort's tax burden. The second figure shows the combined net benefit, which is positive across the sector, but again favors those companies with less leverage.

Seer Capital Management LP
1177 Avenue of the Americas, 34th Floor
New York, NY 10036
(212) 850-9000
www.seercap.com

**2018 component impact from tax reform by leverage bucket**




**2018 combined impact from tax reform by leverage bucket**




In the Leveraged Loan space, a similar analysis was done, which also revealed a net positive from corporate tax reform. The figure below shows how each of the four tax reform components might impact the Leveraged Loan space, in the first year, and then as the code changes in 2022 and 2024. The boost is expected to decline over time but remain positive through the next decade. Overall, Leveraged Loan credits are expected to realize the maximum benefit from tax reform in 2018, saving $10bn or roughly 7.5% of their EBITDAs. By year 2022, the interest deductibility becomes more stringent. By 2024, the

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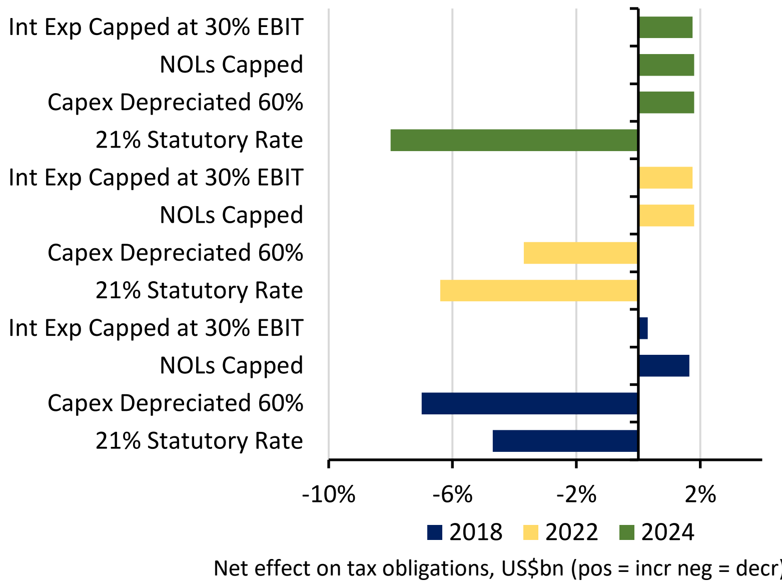
capex windfall declines again, becoming even less of a benefit. Yet issuers are expected to continue to see a net benefit (lower tax obligation) amounting to 5.2% of EBITDA in 2022, falling to 2.7% in 2024.

**Leveraged Loan – Tax Reform Impacts by Time Period***




** excludes analysis of REITs, Utilities, and Financials*

Standard and Poor's recently published their own analysis of the impact of tax reform on corporate credit. They expect that less than 10% of corporate issues might see a ratings change (likely only a notch), with upgrades and downgrades equally probable. This assumes that companies are unlikely to use their tax savings to pay down debt.

Using on our own model and assumptions, we looked at companies sorted by interest coverage ratios. We found that companies with interest coverage above 2.45x are net beneficiaries of tax reform. The median interest coverage for Leveraged Loan borrowers in the LSTA Index is currently 4.1x. We estimate that about one in five LSTA borrowers have interest coverage below 2.45x and will be worse off under the new tax code. This does increase tail risk in CLOs. In recent conversations with CLO managers, they have updated their underwriting to reflect the new tax code and are particularly mindful of those industries and credits least likely to benefit. Given very strong secondary market loan prices, we expect that some managers might take the opportunity to lighten up on issuers who are less favored by the new tax plan.

The biggest tax reform issue for Leveraged Loans is the limits on interest deductibility. While the preceding analysis suggests that these limits will not be material enough to weaken Leveraged Loan issuers, there are situations where these caps may be more of a burden. First, as interest rates go up, more issuers will come up against the cap for deductibility. While higher rates should be accompanied by a stronger economy and hence higher cash flows, for any given issuer there are any number of reasons why that might not be the case. However, one analysis shows that, for example, HY issuers will still see a lower tax bill even with a 300bps increase in average coupons and no change in earnings.

The second risk concerns the pro-cyclical nature of the cap. Because the cap on interest deductions is a function of earnings, a struggling issuer may see their earnings decline exacerbated by an increased tax burden. Generally, one would prefer fiscal policies to be counter-cyclical, and ameliorate downturns, rather than pro-cyclical, and potentially exacerbate downturns. The magnitude of this effect is expected to be small in aggregate but may be quite harmful for any given credit, once again highlighting the need throughout structured products to analyze credit at the most granular levels.

**Conclusion**

Optimally, tax reform will spur economic growth (but not too much, too fast) and nudge corporations to de-lever. If that occurs, it will give the current, benign, credit cycle new legs. On top of lowering the tax burden, a chief aim of this tax reform is to shift incentives away from debt and in favor of capex by making it more expensive to borrow, after-tax, and less expensive to invest, after-tax. Given the current strength of markets and robust valuations, markets are arguably strong enough to weather a pullback in the use of leverage (for both corporations and individuals). In that sense tax reform may provide not only a boost to growth but also an opportunity to perhaps prevent the kind of excessive leverage that led to the Great Recession.