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Middle Market U.S. Companies Are 'On Sale' Indefinitely for Foreign Buyers
By Marty Wolf

This will be a banner year for foreign buyers looking to acquire middle market U.S. companies. That's because U.S. tax policy has been broken for a long time, and on January 1, 2013 it got worse.

I've been watching this parade for a long time – making deals for 20 years and in the middle market M&A business for 15 of them. I know that factors that affect company valuations are like a pendulum – they swing one way and someone benefits; they swing back the other way and someone else benefits.

But when it comes to U.S. tax policy, the pendulum swings one way – and in the wrong direction. So if you think the post-holiday sales at Saks Fifth Avenue look good, you should see the discounts on middle market companies – those with annual revenue in the $100 to $500 million range – based in the United States.

A Buyer's Market

Let's start with a simple fact. A company's worth to a potential buyer is the present value of its future cash flows. There are several ways to calculate present value of future cash flows, all of them complicated. But two critical factors that influence it are easy to understand: inflation and taxes.

Simply put:

- When inflation is high, a dollar tomorrow is worth less than a dollar today.
- When taxes are high, there are fewer dollars to invest in a business, return to shareholders or retain in a business to build equity.

High inflation and high taxes – alone or combined – make companies a less attractive asset. So where do we stand right now on inflation and taxes?

Low inflation: Inflation in the United States is very low. Put one in the plus column for company valuations.

High taxes: The U.S. federal corporate tax rate is 35% – the highest in the developed world.

In addition, on January 1st, as part of the deal to avoid the fiscal cliff, taxes on individuals who make more than $400,000 and couples earning more than $450,000 increased from 35% to 39.6% – and with certain deduction phase-outs can be as high as 41%.

Moreover, taxes on dividends and capital gains increased from 15% to 20% on January 1st. Add to this the previously mandated 3.8% Medicare tax on unearned income for singles earning more than $200,000 and couples earning more than $250,000, and taxes on dividends and capital gains for upper income Americans is now 23.8%.

The Business vs. the Individual

Why are individual, dividend and capital gains tax rates relevant in a discussion of enterprise valuations? Because a large number of middle market businesses are closely held and structured as partnerships, limited liability corporations (LLCs) or S corporations. In these types of entities, business income flows through to owners and is taxed at the federal level at individual rates.

And while operating expenses in these types of companies can be paid with pre-tax dollars, capital investments such as land and buildings must be made with after-tax dollars. This is a fact that business owners understand and policymakers either don't know or don't care about.

Bottom line, taxes on companies in the United States are high, but if business income flows through to individuals, they are even higher.

So for taxes, put one in the minus column.

Consider the Dollar

Wrapped around the question of taxes is currency. The Fed has been steadily devaluing the dollar by introducing new money into the money supply in an attempt to prevent deflation, stimulate growth and make it cheaper to pay off the national debt. But devaluing the dollar affects companies that import or export goods and services or make foreign investments.

For these companies, high taxes and a devalued dollar is a double whammy. If a company wants to repatriate the money it has earned overseas, it faces paying 35% of it in federal taxes and being on the losing end of a currency exchange transaction.

That's why U.S. companies with operations overseas are holding more than a trillion dollars in cash and short-term cash equivalents right where they earned it: overseas. They are hoping for a repatriation tax holiday that may never come.

To be fair, there is a difference between the statutory corporate tax rate and what a company actually pays in taxes. That's because large, multinational enterprises with sophisticated tax departments and accounting firms can reduce the taxes they pay through special deductions, tax credits or transfer payments between their various units in different countries.

Large multinationals can also move existing operations or establish new ones in foreign countries with lower tax rates and the keep or invest the cash they earn there instead of bringing it home and reinvesting it here.

But let's be clear about one thing. While it's sound business strategy for a company to reduce its taxes if it can, all of these maneuvers add complexity and come with additional compliance burdens. Wouldn't it better if companies could spend less time on activities that lower taxes and more time investing in activities that improve their business performance?

And let's be clear about something else. Many of the complex tax strategies employed by large multinationals are simply not available to middle market companies. So their effective tax rates are closer to the statutory rate – and nearly always much higher than their counterparts in other countries.

And that's what makes middle market companies in the United States such a bargain to foreign buyers.

What Are They Buying?

Prime targets will be small public companies trading at discounts to their peer groups and the overall market and closely held partnerships, LLCs and S corps in industries such as IT services, software, healthcare, financial services, and various industrial and consumer products.

One example of such a company is AdvizeX Technologies, LLC, a cloud computing and data center solutions provider headquartered in Cleveland, Ohio. AdvizeX was acquired by the U.S. arm of Mumbai-based Rolta India Limited, an IT services leader with annual revenues of $336 million. The purchase price was $32 million. (Full disclosure: my firm was the M&A advisor in the transaction.)

Let's use this acquisition as the basis for a simplified hypothetical example.

A $100 million U.S. middle market IT services company making a 4% pre-tax profit and a comparable company in Canada are both being considered for acquisition by a larger IT firm based in India looking for a physical presence and access to customers in North America. From the buyer's perspective, how much is each company worth?

Let's do the math.

With U.S. corporate taxes at 35%, the U.S. company would pay $1.4 million in federal taxes. Meanwhile, with Canadian corporate taxes at 15%, the Canadian company would pay $600,000 (see Table 1.) (For purposes of this example, we're talking about U.S. dollars for both companies.)

Table 1: Hypothetical Example: Impact of National Tax Policy on Enterprise Value

	Revenue*	Pre-tax Profit	Corporate Tax Rate**	Taxes	Value
U.S. IT Company	$100 million	$4 million	35%	$1.4 million	$20.8 million
Canadian IT Company	$100 million	$4 million	15%	$600,000	$27.2 million

** The tax rates are federal corporate tax rates for the United States and Canada only, and do not include state, provincial or local taxes, where they might apply in each country and that are variable.

Now, given that the enterprise value of an IT company fitting this profile could be 8 times income after taxes, the U.S. company is worth $20.8 million and the Canadian company $27.2 million – or 31% more. As a buyer, all things being equal except taxes, which company is the bargain?

Of course, all things are never equal between two companies. But a 31% discount adds up to real money and must be considered.

For example, the actual U.S.-based AdvizeX sold for $32 million. If a hypothetical Canada-based AdvizeX could sell for 31% more, that would add $9.9 million to the price tag.

And how about what might happen after the Indian company purchases the U.S. company in our hypothetical example?

With the corporate tax rate in India at 30% and no additional local taxes, it would make sense for the new parent to outsource much of the work now being done in the United States to its Indian operations. As a sweetener, wages are lower in India.

Blame U.S. Tax Policy

So before long, the United States would be losing jobs in addition to the equity, profits – and yes, even tax revenue – from this business.

Bottom line, current U.S. tax policy is turning U.S. companies into bargains for foreign buyers. And not just for a few days in January – like a post-holiday sale at Saks – but every day for many years to come.

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