**Investment Overview**

With President Trump now in office, there has been much talk about lowering corporate taxes. Both President Trump and Speaker Ryan have put forth proposals that entail a number of changes to the corporate tax code. Based on these proposals, it is difficult to predict which companies will benefit and which companies will be hurt by the proposed changes. We believe automakers and suppliers, apparel and footwear manufacturers, discount retailers, and retailers with large private-label offerings are most at risk of being negatively impacted. However, given the very high level of uncertainty of eventual changes and their impacts, we recommend investors do not make decisions based on speculated tax policy.

**More Than Just a Lower Tax Rate**

While both President Trump and Speaker Ryan's proposals recommend lowering the corporate tax rate, there are number of other proposed changes that, for some companies, have the potential to more than offset the benefits of a lower tax rate. One of the most controversial changes suggested is the implementation of a border-tax adjustment. As an example, let's look at a hypothetical apparel manufacturing company. The company makes a shirt overseas, which costs $80 to produce. The company then sells the shirt for $100. This equals a $20 profit.

Under current law, the company would pay a 35% tax rate on its $20 of profits, for a $7 tax bill and $13 in after-tax profits.

**Scenario 1: Current 35% Corporate Tax Rate**

\[
\text{Profit Before Tax} \times \text{Current Corporate Tax Rate} = \text{Taxes Paid} \rightarrow \text{After Tax Profit}
\]

\[
\$20 \times 35\% = \$7 \rightarrow \$13
\]

Let's assume the corporate tax rate is lowered to 20%. In this scenario, the company would now pay a 20% tax rate on its $20 profits, for a $4 tax bill.

**Scenario 2: Corporate Tax Rate Is Lowered to 20%**

\[
\text{Profit Before Tax} \times \text{New Corporate Tax Rate} = \text{Taxes Paid} \rightarrow \text{After Tax Profit}
\]

\[
\$20 \times 20\% = \$4 \rightarrow \$16
\]

The company benefits in this scenario from a lower tax rate and now makes $16 in after-tax profits.
In the next scenario, let's assume the corporate tax rate has been lowered to 20% and there is now a border-tax adjustment, as has been suggested in the current proposals. This means our apparel company must now not only pay taxes on its profits, but also on all the costs to make a shirt overseas. The company would pay a 20% tax rate on both its $20 profits and its $80 cost to produce the shirts overseas, for a $20 tax bill.

**Scenario 3: Corporate Tax Rate Is Lowered to 20% and a Border-Tax Adjustment Is Implemented**

<table>
<thead>
<tr>
<th>Profit Before Tax</th>
<th>Cost to Produce Shirt Overseas</th>
<th>New Corporate Tax Rate</th>
<th>Taxes Paid</th>
<th>After Tax Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20</td>
<td>$80</td>
<td>20%</td>
<td>$20</td>
<td>$0</td>
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</tbody>
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In this case, the border-tax adjustment wipes out the company's profits. The company could have to increase prices to offset the higher tax bill and/or manufacture part of the shirt in the U.S. to reduce its tax burden. This example is extreme since most companies do not have all of their costs overseas. The reality of implementing a border-tax adjustment is more complicated than our example and could have a number of effects that could meaningfully change how it impacts a company's profits. For instance, many economists believe that if a 20% border-tax adjustment is implemented, the U.S. dollar will increase by 25%. If this happens, it would increase a U.S. company's buying power overseas, effectively lowering the cost to produce overseas. In the case of our apparel manufacturer, a 25% increase in the dollar would lower the cost to produce shirts overseas to $64. If the company still sells shirts for $100, their profits before tax increase to $36.

If we apply a lower 20% corporate tax rate and a 20% border-tax adjustment, the company's tax bill is $20, the same as it was in **Scenario 3**.

**Scenario 4: Corporate Tax Rate Is Lowered to 20%, a Border-Tax Adjustment Is Implemented, and the Dollar Rises 25%**

<table>
<thead>
<tr>
<th>Profit Before Tax</th>
<th>New Cost to Produce Shirt Overseas</th>
<th>New Corporate Tax Rate</th>
<th>Taxes Paid</th>
<th>After Tax Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$36</td>
<td>$64</td>
<td>20%</td>
<td>$20</td>
<td>$16</td>
</tr>
</tbody>
</table>

However, in this scenario, the rise in the U.S. dollar increased the company's profit before tax, which offset the negative impact from the border-tax adjustment. The after-tax profit is now the same as in **Scenario 2**, the lower corporate tax rate scenario, meaning our shirt manufacturer would still realize an increase in profits compared with profits from current tax rates.

The border-tax adjustment is one of many unknowns when it comes to potential changes to the corporate tax code. There is also a chance a border-tax adjustment or an import tax would not be allowed by the World Trade Organization. Also, President Trump has recently made comments that he'd prefer a tax on imports to a border-tax adjustment. An import tax could be broad-based or only apply to certain industries, but in either case, could impact companies differently than our example.
What Is the Likely Outcome?

There will likely be many modifications to the current proposals. Also, any changes to the tax code would have to be approved by both the House and Senate, meaning it will likely take time before we see any definitive changes. It is difficult to predict what changes will be made to the corporate tax code, the effect of those changes on currency and other markets, and ultimately what the impact will be on company profits. We do know that just because the corporate tax rate could be lowered, benefits will vary by company, and there is a risk some companies could end up paying more in taxes depending on what changes are made.

What Does This Mean for Consumer Companies?

Based on this very simple example of only one potential outcome, we believe companies that manufacture or source their products in the U.S. and have mostly U.S. operations have the potential to benefit the most from corporate tax reform. We believe companies with large international operations would likely see a smaller benefit given they already pay lower tax rates. Lastly, we believe companies that source or manufacture products overseas are at the greatest risk of seeing their tax bills increase.

- **Sectors Most Likely to See Neutral or Positive Impacts**
  - Consumer Staples
  - Media
  - Restaurants
  - Select Domestic Retailers

- **Sectors Most at Risk to See Negative Impacts**
  - Automakers and Suppliers
  - Apparel and Footwear Manufacturers
  - Discount Retailers
  - Retailers With Large Private-Label Offerings

In our view, consumer staples companies, media companies, restaurants and select domestic retailers are most likely to see neutral or positive impacts from changes in the corporate tax code. Meanwhile, we believe automakers and suppliers, apparel and footwear manufacturers, discount retailers, and retailers with large private-label offerings are most at risk of being negatively impacted. We have seen some companies in these industries underperform recently due to these concerns.

Recommended Action for Investors

We do not believe investors should base investment decisions on potential corporate tax code changes given that there are many unknowns and that the potential impact to earnings could be much different than the simplified scenarios we laid out above. There are several proposals for tax reform on the table, and each specific company has its own unique tax situation with its own complexities. The uncertainty surrounding the impact of potential tax policy changes should serve as a reminder for the importance of diversification. Investors should own stocks within a variety of sectors and subsectors to potentially limit the impact from specific industry risks. We strongly recommend not investing based on speculated tax policy, but rather we recommend investors focus on a company’s long-term earnings growth potential, and we point investors to our Buy-rated companies.
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