

Tax reform: one step closer to reality. US micro caps should disproportionately benefit.

By Thomson Horstmann & Bryant, Inc.

With US tax reforms now one step closer to reality, and a strengthening US economy, THB outlines in this paper how smaller US companies (the focus of the THB US micro cap strategy) should disproportionately benefit. Increased cash flows from reduced taxes and lower regulatory costs will provide both organic and inorganic growth opportunities.

Introduction

The speculation over the possibility and timing of tax reform passing has dominated US news headlines for the better part of 2017. That possibility came one step closer to reality late last week when the Senate passed revisions to the US tax code that would result in \$1.4 trillion in tax cuts. The next step involves a reconciliation between the House and Senate versions of the plan and a final bill for President Trump to sign expected sometime before Christmas.

We believe the passage of a final bill will inject additional stimulus into an already strengthening economy and that the dual tailwinds of tax reform and a more favorable regulatory environment, which is already underway, will disproportionately benefit smaller US companies that are among the most unduly burdened by higher taxes and regulatory costs.

Corporate tax rate cut from 35% to 20% in 2019

A primary component of the proposed bill includes cutting the corporate tax rate from 35% to 20% starting in 2019 to make the US more competitive with the rest of the world. The tax cut should broadly benefit US corporations and provide additional stimulus to an advancing economy but disproportionately increase the earnings growth of those companies that are currently paying at or close to the highest effective tax rate. Companies that meet this profile are generally smaller companies with a majority of their operations in the US and a relatively small percentage of revenue generated overseas. US micro cap companies are US-centric businesses, many of which are paying at or close to the highest corporate tax rate. We believe the portfolio will directly benefit from a reduction in the tax rate. For example, a portfolio holding that exhibits a reduction in its effective tax rate from 35% to 20% will experience a 25% increase in earnings and cash flow all other things being equal.

Corporations to repatriate cash from overseas accounts at 14.5%

The proposed bill also provides a means for corporations to repatriate cash held in overseas accounts at the relatively low tax rate of 14.5%. The last major repatriation tax holiday occurred in 2004 as part of the American Jobs Creation Act at a 5.25% tax rate instead of the 35% corporate tax rate. An estimated \$400 million of cash was brought back to the US, much of which was used for merger and acquisition activity and/or to pay dividends and buyback shares. Estimates of the amount of cash currently held by US corporations overseas are as high as \$2.5 trillion. Similar to the prior holiday, a large cash infusion resulting from repatriation should provide multiple avenues for companies to generate shareholder value.

Consumer confidence strengthening

Underlying the recent news headlines regarding tax reform are a strengthening economy and solid corporate earnings. The Conference Board’s measure of consumer confidence is now at its highest level in 17 years, and retail sales data have been stronger than expected for the past two months following a robust third quarter. New home sales accelerated to their fastest pace of the current cycle, showing strong demand in all four regions of the US. The ISM manufacturing index continues its strength as 14 of the 18 industries reported gains in production, and 11 industries reported gains in employment. Further, broad-based gains in new orders offer a positive signal for continued economic growth ahead.

Conference Board Consumer Confidence Index (Dec 2001 to Nov 2017)

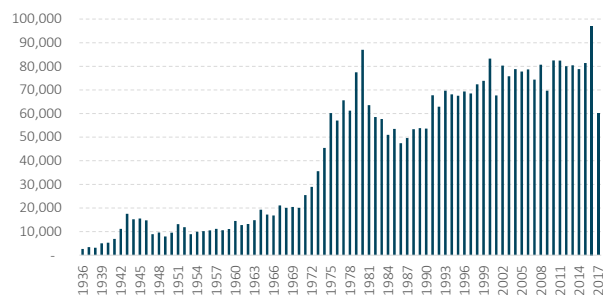


Source: The Conference Board

An easing of the regulatory burden

Additionally, despite garnering less media attention, the US is undergoing a shift away from burdensome regulation toward more business-friendly initiatives to encourage investment. Concrete steps have already been taken to ease the regulatory burden on the financial industry, including changes to make it easier for banks to lend money to consumers and small businesses, changes to stress test frequency and severity, lower leverage ratios, exemptions from the Volcker Rule for smaller institutions, and the relaxation of capital requirements especially on smaller financial institutions.

Federal Register Pages Published (1936-2017)



Source: US Federal Register

Further evidence of deregulation is highlighted by The Federal Register, a measure of government regulation, which totaled 45,677 pages through September 30, 2017, a 33% decline over the same time frame in the prior year. It is on track to comprise approximately 60,000 pages for the full year 2017, which would represent a 40% decline from the all-time record of 100,000 pages published in 2016.

Smaller US companies to disproportionately benefit

We believe lower taxation combined with strengthening economic conditions and a less burdensome regulatory environment will inject additional stimulus that will disproportionately benefit smaller, US-centric companies. As we speak with a wide range of management teams of small US companies, there is general consensus that the excess cash flows from reduced taxes and lower regulatory costs will provide both organic and inorganic growth opportunities such as increased merger and acquisition activity, share buybacks, and growth capital expenditures.

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Investment Strategy – THB US Micro Cap Fund

Thomson Horstmann & Bryant, Inc. (THB) is an employee-owned boutique investment management firm based in Connecticut specialising in smaller company strategies. THB's US micro cap strategy is based on the belief that there are inefficiencies in the micro cap segment of the market due to lack of analyst coverage, difficulty in identifying value and the impact that management skill has on the direction of smaller companies. THB utilises a disciplined, fundamental bottom-up approach that blends both qualitative and quantitative methods to construct a well-diversified portfolio of companies that possess attractive operating metrics, yet with comparable valuation to the Russell Microcap® Index.

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