UNIVERSITY of VIRGINIA

DARDEN SCHOOL of BUSINESS

VIEWS FROM THE C-SUITE:

It's All About the Stimulus:

The Trump Administration's Tax Cuts and Jobs Act

BY

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Views from the C-Suite

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The University of Virginia Darden School of Business Institute for Business in Society held its Strategic CFO Roundtable on 4 January 2018 in Arlington, Virginia.

Since 2008, these roundtables have provided a confidential forum for corporate financial leaders representing the varied industries of the Washington D.C. region to discuss global and U.S. economies as well as corporate financial strategies and performance.

In addition, each roundtable focuses on a Top of Mind (ToM) topic, a specific issue of immediate importance to the members. For the January 2018 roundtable, the ToM topic was, *It's All About the Stimulus,* a reference to the newly-enacted Tax Cuts and Jobs Act.

THE ECONOMIC DISCUSSION

The January roundtable met just a few days after the markets closed for 2017, ending yet another stellar year for the stock market. For 2017, the Dow Jones Industrial Average returned 25.1% to investors (28.1% if dividends were reinvested). As evidence of the market's buoyance, the Dow hit 9 record highs in the month of December and was continuing its ascent toward another record high of 25,075 on the day of the roundtable. Following 2008, when the market fell 34%, the ensuing 9 years have all had positive stock market returns, except for 2015 when the Dow fell by 2.2%. The 2017 return ranks are the second highest behind the 26.5% return for 2013. The average return for 2009-2017 has been 12.5%, a period during which yields for 10-year Treasury bonds averaged 2.47%.

Part of the most recent exuberance by investors is the celebration of the passage of the Tax Cut and Jobs Act, which significantly reduces both personal and corporate tax rates. By all accounts this act represents the most comprehensive tax reform since 1986. The highest corporate tax rate will be reduced from 35% to 21%, seeking to make U.S. companies more competitive internationally and the U.S. more attractive for investment by non-U.S. based companies. Estimates vary as to whether the stimulus impact upon

GDP will warrant the $1.5 trillion budget deficit created by the lost tax revenues over the next decade. Despite that debate, investor sentiment as measured by the stock market is giving the new law a ringing endorsement and as was true for the September roundtable; the roundtable CFOs reported levels of optimism for the U.S. economy and for their own companies in excess of 60%, well above the neutral point of 50%.

Darden Regional Business Outlook Survey

Before each roundtable, the members participate in a survey designed to elicit insights into their business views relative to national counterparts. For a couple of key questions, we compare members' responses with those of the Duke University/CFO Magazine Global Business Outlook Survey (the "national survey') which has polled senior finance executives nationwide over the past 87 quarters. The comparison of results serves to generate conversation regarding member expectations of the financial condition and outlook for the U.S. and global economies and their own companies.

Economic Outlook

Figure 1 depicts how the respective CFO groups have rated their optimism regarding the U.S. economy on a scale of 0 – 100%, where 0% indicates "Not Optimistic" and 100% indicates "Extremely Optimistic." The January 2018 Darden Strategic CFO Roundtable Survey (dashed line) revealed a slight decrease of 4.6% in optimism regarding the U.S. economy relative to the September 2017 Survey: 63.2% and 67.8%. The national survey (solid line) reported an optimism level of 73.6%, which was an increase of 6.2%: 73.6% for Q4 2017 and 67.4% for Q2 2017. Over the past couple of years, the Darden Strategic CFO Roundtable Survey has reported optimism levels of approximately 60%. The national survey optimism level was lower than the roundtable survey in 2016, but mostly higher than the roundtable survey for 2017 and noticeable higher for our January survey: 73.6% for the national survey compared to 63.2% for the roundtable survey.

Figure 1: Optimism for the U.S. Economy
(Scale of 0 – 100%)

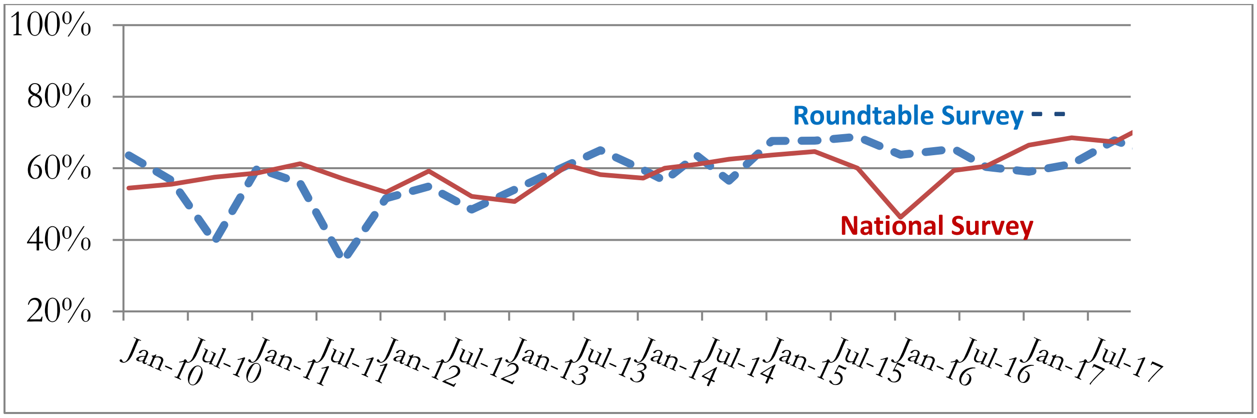
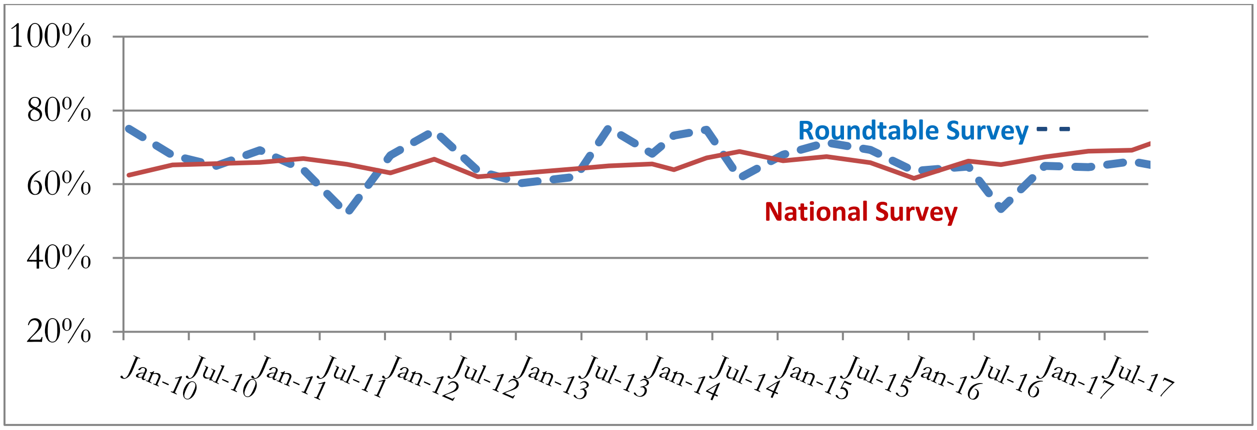


Figure 2 compares the Darden Strategic CFO Roundtable Survey with the national survey regarding optimism for the CFOs' own companies. Both surveys exhibited optimism levels for their own companies that were similar to those reported for the U.S. economy. For the national survey (solid line), optimism was reported as 73.4% and for the roundtable survey (dashed line), optimism was reported as 64.0%. As has been true for the past several quarters, the surveys show little difference between their own companies and U.S. economy optimism levels.

The most notable difference for this survey relative to past surveys is the higher optimism levels for the national survey numbers relative to the roundtable survey. The Q4 2017 national survey reports the highest levels of optimism since we began the Strategic CFO Roundtable Survey in 2010. Moreover, for the first time, the optimism levels are higher than 70%. Although the roundtable survey optimism levels are not as high as those from the national survey, they continue to be strongly optimistic (see Appendix A for more information on the Darden Strategic CFO Roundtable Survey).

Figure 2: Optimism for Their Own Company
(Scale of 0 – 100%)



When asked for their reflections regarding the high levels of optimism, one roundtable member noted:

> "I think that a lot of the fundamental numbers just keep steadily improving, so there's a cumulative psychological impact there that's contributing to that [which] helps improve confidence and probably also complemented by the fact that it's not just in the U.S., but globally. I'm sure not every single economy in the world is doing great, but by and large, there aren't any big trouble spots that are getting a lot of headlines."

A second member reflected on the continued improvement in unemployment:

> "With that sort of stability, the volatility gets more stable and then the number that I always look at is the unemployment number which continues to incrementally get better and better, to the point where it's [probably] past pre-2007 levels . . . and it has just gotten there very gradually."

The survey asks members to list their top three external and internal concerns. A frequent response for internal concerns is hiring. This is most often stated as "finding the right talent" or "retaining talent." These same concerns were listed in the January survey, which was reflected in comments regarding the lack of wage increases in the economy:

> "[True that there's] no wage increase, but still overall, it's a really low inflationary environment, so wages and costs [remain low], so that part is a little odd. You think if unemployment gets really low, like in the low 4s, there should be some wage inflation, but it has not happened."

> "In our business, which is more professional services and it's mostly here in DC, but we're linked to other places across the country, it hasn't been a super competitive job market. We're not seeing high attrition. . . . We've had a really good retention. We, obviously, benchmark compensation and there're always some increases we've put in in different places, but it hasn't felt like one of these super white-hot markets where you're chasing people with signing bonuses. We've not really experienced that."

One CFO pointed out that the labor environment was more challenging for higher tech workers:

> "I think there's more optimism [in my industry because] the government is recognizing that they need to get things done. We've seen a big push away from the low cost, technically acceptable proposal evaluations that they were doing when every dollar counted. They now realize that they need to pay for the high level service that they need. So, that's made the competitive environment more technical solution-based versus cost-based. You know, the people are still our biggest challenge.
>
> It's not so much the wages, it's the availability, there's just not enough of them. For us, the clearance process is the big thing we're focused on trying to get the government to fix."

As the discussion about the U.S. economy was closing, the roundtable members considered the survey results regarding expectations of changes in their income statement, balance sheet and cash balance. On average, as they have been reporting for the last few years, the January survey revealed that members were expecting all of these financial measures to improve over the next four quarters.

THE TOP OF MIND TOPIC

For January, the Top of Mind (ToM) Topic focused on the Tax Cuts and Jobs Act (Public Law No. 115-97)(the "Tax Bill"), to reduce tax rates and modify policies, credits, and deductions for individuals and businesses, signed into law by President Trump on 22 December 2017.

The ToM Topic, *It's All about the Stimulus,* theorized that the Tax Bill would be judged as successful if it stimulated a three-phase growth story with each phase being a domino that needs to fall to ignite the next phase.

Domino 1. Middle income working families receive a material tax break going forward.

Domino 2. Substantial part of tax savings translates to higher consumption, which presumes there is pent-up consumer demand, versus increased savings or lowering household debt.

Domino 3. Increased consumer consumption pressures corporate production, benefiting the corporation with increased revenues and the individual sector with new jobs and upward pressure on wages.

If all three dominos fall, most would likely view the tax cuts as having been a successful strategy, even though GDP growth might have continued even without the tax bill (see Appendix B for more information on what will need to happen for the tax bill to be successful).

Before the members delved into the domino effect, Professor Eades asked the members to provide their opinions of the impacts, positive and/or negative, of the Tax Bill on corporations.

We had added specific questions to the survey to gauge the members' views on the tax bill's likely impact on how companies/corporate sectors might spend any tax savings, for instance, dividend increases, share repurchases, debt reduction, capital expenditures, mergers and acquisitions (M&A) and/or wages. In the survey, we also asked the members to assess the impact upon corporate inversions and GDP growth. Their responses are summarized as the third page of the survey results in the appendix.

Our discussion began with the CFOs' initial thoughts of **anticipated impact on corporations.** Collectively, they agreed the impact of the tax bill – and the uses for any incremental cash that results from it – will depend on the type and stage of the company.

For some public companies:

> "The tax rate doesn't help us with . . . [how] investors value us."
>
> "I don't think we would [hire] more people [with the incremental cash from lower taxes] . . . maybe it helps on M&A a little bit, you can get better ROI on M&A, but it would probably mostly be share repurchases."
>
> "We don't pay a dividend [but if we did] we might have considered paying a dividend."
>
> "For my company, in particular, M&A is always our preferred capital deployment, so we're not going to do a share buy-back. We already have a dividend . . . [which we may review] . . . not because of the cash, but just because we've had a constant dividend and now the share price is up so the yield has dropped."

For private companies, the impacts may be very different:

> "As a private equity-owned company, we are highly levered . . . [and] have a larger tax base to step up, so tax loss position. . . . I worry that the deductibility hurts us when we go to sell the business in 3-5 years, that it's going to depress valuations for higher-levered companies . . . if our valuation's going to be depressed and our owner bought it and was expecting a certain amount of return, then we're going to have to generate return by delivering greater EBITDA [earnings before interest, taxes, depreciation and amortization] which means less jobs. I don't know that's going to be the case . . . but I'm worried that's going to have a negative effect on highly levered businesses."
>
> "We're in growth companies that usually don't have a lot of profitability . . . until you get ready to sell them."
>
> One profitable growth company is international although it does business in the States: "It's growing very well, creating a lot of cash, but mostly using that overseas."

Will it result in more hiring or increased wages? Not according to this roundtable.

"I'm surprised at some of the 2s [in the survey results, meaning the companies would likely use tax savings for hiring or wage increases], because in our business [increased hiring and/or wages] would never have been a natural consequence of lower taxes, it usually is going to benefit the owners, not free-up dollars to spend more."

"Hiring depends on growth. Growth depends on demand. The entities we're serving . . . have no benefit from the tax impact. There's no increased demand for us . . . but it may just be because we're in sectors where the tax rate's not going to impact, benefit our customers, and therefore is not going to change their buying habits."

"Our [compensation] is market-based, right? So, we will change compensation if we feel like our attrition rates are increasing, if our offer and acceptance rates are decreasing, [if] we can't get the people we need. . . supply and demand [of personnel] is its own market."

"I could see a lot more M&A happening…as a result of tax reform . . . if we're trying to . . . find growth. One of the ways to grow is inorganically and if I have extra cash, I'm not going to be hiring for jobs, but if I could buy a business that's already growing, I could deploy it there."

What about repatriation of dollars?

"Do they have a use for it when they bring it back?"

"I'm on the board of a little healthcare IT company. We're beginning to see some of those dollars come back in terms of potentially purchasing some of our products and services. So, we're hopeful that will actually be fully realized, it's right now more talk than it is contract. At least the talk is starting."

"We set up this whole IP transfer structure a couple of years ago. . . historically [we had more of a] management services agreement. We changed that . . .we sold [our international subsidiaries] the IP and then they were able to generate revenue . . . to take advantage of a lower tax jurisdiction. . . . I just wonder, would we . . . go back now and re-visit that and whether it made sense to unwind that for the future and what that would have meant?"

"I think the repatriation question is one that is probably for some of the multinationals, it's a very, very important question with all those dollars sitting overseas."

On January 18, 2018, just after our roundtable discussion, Apple Inc. announced it will pay an estimated $38 billion in taxes as mandated by the new law for its accumulated foreign cash holdings of $252 billion. This represents about a $50 billion tax savings if Apple had chosen to repatriate the cash under the 35% corporate tax rate. The cash can be put to good use to fund Apple's 5-year plan to contribute $350 billion and 20,000 new jobs to the U.S. economy (includes new investments and Apple's current pace of spending).

Will we see the three dominos topple - delivering the full growth story as a result of this bill?

"If we're going to have the U.S. economy grow, there has to be some demand that's created and this starts at the retail bases, looking at the taxpayers. I've seen so widely variable answers to this, it's not clear how much of a tax break the average person is going to get. It should change the withholding, in fact those rules will come out, so you will see the cash sooner. So, there's that question and how much do they get. And, how do they actually spend it? How much wealthier, how good do you feel?"

Domino 1 - middle income working families receive a material tax break. CFOs were skeptical about the materiality of the tax break, which could stop the domino chain before it even gets started:

"I think, ultimately, the people have to have the money in their pocket."

"There's all of this uncertainty and skepticism . . . they're going to get that paycheck that's gone up ten bucks and aw thanks, but that's two cappuccinos for their experience and they're done, maybe one, I don't know, the point is it's not much."

Domino 2 - a substantial part of tax savings translates to higher consumption. CFOs cited reasons for consumption, but also for de-levering:

> "One thing that we've seen a trend in overtime [since 2008] is de-levering individual's balance sheets. . . . It's still happening, though, not at the rate it was."

> "But you also see credit card debt ticking up and so that's, I think, saying that people are starting to spend on the retail level a little bit more."

Domino 3 - increased consumer demand produces new jobs and upward pressure on wages. One CFO summarized the precariousness of getting the final domino to fall:

> "Does this [tax bill] kick the economy into a different place? It's back to the forecast, the forecast is sort of somewhere, hopefully in the middle. It could be worse; the uncertainty will overcome everything else and the [tax savings] won't really matter to people. If the psyche can change then it will probably end up being a lot better and it will pay for itself. But, I think it's more about psyche change than about a forecast with its pile of assumptions."

The Darden Strategic CFO Roundtable meets again on 8 May 2018.

About the Authors

Kenneth M. Eades, Professor of Business Administration, is the Chairman of the Darden Finance Department and Associated Faculty with the Institute for Business in Society. The author of numerous academic articles, more than 70 Darden cases and three books, Ken has received both research and teaching awards.

Jane-Scott Cantus, Managing Principal and General Counsel of The ILEX Group, has worked with and advises Board and C-Suite members on strategy, culture, organizational design, leadership and talent for over 25 years. She co-founded the Strategic CFO Roundtable with Professor Eades and is a Fellow with the Institute for Business in Society.

About the Darden Strategic CFO Roundtable

The Darden Strategic CFO Roundtable is an invitation-only peer-to-peer forum for leading chief financial officers in the Washington D.C. metropolitan area. The roundtable members discuss, debate and share best practices surrounding the strategic role of the CFO. Representing a collective 300+ years of strategic, financial and leadership experience, the roundtable members share their views on the challenges and opportunities facing their companies and themselves. They discuss the lessons learned from triumphs and trials that led to their becoming recognized as strategic CFOs. Founded in 2008 by Darden Professor Kenneth M. Eades and Jane-Scott Cantus of The ILEX Group, the Strategic CFO Roundtable became a branded initiative of the Institute for Business in Society at the Darden School of Business of the University of Virginia in 2013.

About the Institute for Business in Society at the UVA Darden School

The Institute for Business in Society is a Center of Excellence at the Darden School of Business at the University of Virginia. Its mission is to be a leading global catalyst and convener of thought, information and action at the convergence of business and society. To achieve that mission, the institute unites leaders in business education with top industry executives, regulators and other thought leaders in discourse on the role and responsibility of business to make lasting positive impact to better an increasingly complex global society.

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Appendix A

Darden Strategic CFO Roundtable Survey Results, January 2018

	N = 5 CFO RT Jan 2018		N = 6 CFO RT Sept 2017		N = 9 CFO RT May 2017		N = 6 CFO RT Jan 2017		N=259 (56) National Q4 17		N=354 National Q2 17		N=361 National Q1 17	
	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median
1. Compared to last quarter, are you more or less optimistic regarding:-**U.S. economy** (Less =1, More = 3)	**2.6**	**3.0**	2.0	2.0	2.3	2.0	2.7	3.0	2.5	3.0	2.2	2.0	2.5	3.0
1. Compared to last quarter, are you more or less optimistic regarding:-Financial prospects for **your own company** (Less =1, More = 3)	**2.6**	**3.0**	2.2	2.0	2.4	2.0	2.3	2.5	2.4	3.0	2.3	2.0	2.4	3.0
2. Rate your optimism regarding: (Drag the slider to assign a number.)- **U.S. economy**	**63.2**	**60.0**	67.8	70.0	61.2	60.0	59.0	63.0	73.6	75.0	67.4	70.0	68.5	70.0
2. Rate your optimism regarding: (Drag the slider to assign a number.)-Financial prospects for **your own company**	**64.0**	**58.0**	66.2	60.0	64.7	60.0	65.0	60.0	73.4	75.0	69.2	75.0	69.0	75.0
5. How would you rate...-Your **employees' morale level**? (Poor =1, Satisfactory =3, Excellent = 5)	**3.0**	**3.0**	3.7	4.0	3.0	3.0	3.7	4.0						

The national survey is conducted by Duke University's Fuqua School of Business and CFO magazine. For Q4 2017 the results were divided into responses received before December 2, 2017 (N= 203) and responses receive after December 2 (N = 56). The responses received after December 2 were based on information similar to that of the CFO Roundtable Survey, particularly with regard to the Tax Reform Act. Therefore, to facilitate a more meaningful comparison, the national survey results reported are for the responses received after December 2 (N = 56).

	N = 5		N = 6		N = 9		N = 6	
	CFO RT Jan 2018		CFO RT Sept 2017		CFO RT May 2017		CFO RT Jan 2017	
(Weaker =1, No change = 2 Stronger = 3)	Average	Median	Average	Median	Average	Median	Average	Median
6. Recent quarter's financial results **vs. previous quarter: -Income Statement**	**2.2**	**2.0**	2.5	2.5	2.3	2.0	1.8	1.5
6. Recent quarter's financial results vs. previous quarter: - **Balance Sheet**	**2.0**	**2.0**	2.0	2.0	2.4	2.0	2.2	2.0
6. Recent quarter's financial results vs. previous quarter: - **Cash Balance**	**2.0**	**2.0**	1.8	2.0	2.3	2.0	2.2	2.0
8. **Expected change** over the next 4 quarters vs. last 4 quarters: **-Income Statement**	**2.5**	**2.5**	2.2	2.0	2.6	3.0	2.5	3.0
8. Expected change over the next 4 quarters vs. last 4 quarters: - **Balance Sheet**	**2.3**	**2.5**	2.0	2.0	2.5	3.0	2.3	2.5
8. Expected change over the next 4 quarters vs. last 4 quarters: - **Cash**	**2.3**	**2.5**	2.0	2.0	2.5	3.0	2.2	2.0
(Reduced =1, No change = 2, Higher = 3)								
9. **Expected change** over the next 4 quarters vs. last 4 quarters: - **Headcount**	**2.4**	**3.0**	2.0	2.0	2.1	2.0	2.3	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Capital Spending**	**2.0**	**2.0**	2.0	2.0	2.1	2.0	1.8	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Compensation**	**2.2**	**2.0**	2.0	2.0	1.9	2.0	1.8	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Pro develop/training**	**2.0**	**2.0**	1.8	2.0	2.3	2.0	2.0	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Prob (new mkt/product)**	**2.3**	**2.0**	2.5	2.5	2.5	3.0	2.3	2.5
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Prob (Acquisition)**	**2.3**	**2.0**	2.2	2.0	2.3	2.0	2.2	2.5

10a. How do you predict Your Company will spend the tax savings created by the Tax Cuts and Jobs Act?
(1 = Unlikely, 2 = 50/50, 3 = Likely)

	Average
Initiate or increase dividends	1.33
Initiate or increase share repurchases	1.00
Reduce debt	1.67
Increase capital expenditures	1.50
Increase M&A activity	1.00
Wages will be increased	2.00

10b. How do you predict the overall Corporate Sector will spend the tax savings? (1 = Unlikely, 2 = 50/50, 3 = Likely)

	Average
Initiate or increase dividends	2.60
Initiate or increase share repurchases	2.60
Reduce debt	2.40
Increase capital expenditures	1.80
Increase M&A activity	2.40
Wages will be increased	2.00

11. Will this law stem the flow of corporate inversions by being more competitive on corporate taxes with other countries? (1 = Strongly disagree, 2 = Disagree, 3 = Don't know, 4 = Agree, 5 = Strongly Agree)

Average
4.20

12. Will the tax law have a significant impact upon GDP growth?
(1 = Strongly disagree, 2 = Disagree, 3 = Don't know, 4 = Agree, 5 = Strongly Agree)

Average
3.00

Appendix B

It's All About the Stimulus: What if the proponents of the tax bill are correct?

By Professor Kenneth Eades

Tax Bill proponents see the tax cuts for individuals and corporations as providing cash flow that will stimulate GDP growth. The critics of the Bill draw the opposite conclusion, i.e., the cash flows from the tax reductions will not be enough to spur economic growth, but rather will primarily serve to increase budget deficits and the national debt.

I like to frame this as a debate about the "dominos" that need to fall in order for the tax bill to be successful. Here's my list of the three dominos that are critical to making the tax overhaul a successful stimulus for the economy:

1. Middle income working families receive a *material* tax break going forward; i.e. logic would tell us that if the median household income is about $60,000, the tax law needs to deliver more than a few hundred dollars in order to make Americans feel like they can afford to buy more goods and services. The Tax Policy Center estimates that the Senate's tax bill would give about $800 on average to households with earnings in the range $50,000 - $87,000.

2. A substantial portion of the tax savings translates into higher consumption. Armed with a windfall of cash, each household will choose between how much to spend and how much to save. One view is that families have experienced low growth in income over the past decade and have been postponing consumption. Therefore, most of the tax relief should go to satisfy the pent up demand rather than used for savings or to reduce household debt. For example, if the average tax reduction is $800, the average spending increase should be about $500 per household.

3. The increased consumption spending by individuals puts pressure on corporate production such that the corporate sector increases capital expenditures in order to increase production capacity to meet demand. The corporate sector benefits from the increase in demand and the individual sector benefits from the creation of new jobs and upward pressure on wages.

The first two "dominos" represent the simply growth story: the loss of tax revenues in the short run is more than offset by the rise in tax revenues created by the increase in aggregate economic activity. The last domino is the full growth story whereby GDP rises further due to investments in capacity by the corporate sector. This also puts upward pressure on wages as companies look for more employees to meet the elevated demand. If we see all three dominos fall, most would judge the tax cuts to have been a successful strategy, even though we cannot conclude with complete confidence that much of the GDP growth may have occurred even without the tax bill.