INSIGHTS FROM THE
ACCORDION ROUNDTABLE

The Trump Presidency's Impact on Private Equity

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Throughout the country, businesses and political organizations alike are waiting to see what a Trump administration will mean for them. This has been reflected in the equities markets, which have hit — and subsequently withdrawn from — all-time highs, seemingly unsure of which direction to go.

For the private equity industry, the campaign trail brought frequent attacks on the tax treatment of carried interest and promises of limits on interest deductibility. However, since the inauguration, Trump has loaded his cabinet and advisor roles with a who's who of private equity and Wall Street alums.

At our most recent Accordion Roundtable, we sat down with Mike Sommers, President and CEO of the American Investment Council, and a small group of private equity professionals at KKR's offices in midtown Manhattan to help us make sense of the signs pointing to how the industry is likely to be affected by the Trump Presidency.

SETTING THE STAGE

The aftermath of the Trump victory means that the Republican party now controls more executive and legislative seats than either party has at any other time since the New Deal. From the local races up to the national level, the 2016 election season was a resounding win for the Republicans.

> *"Every Washington insider thought Hillary was going to win, but all of the cab drivers I spoke with said a Trump win was a no-brainer."*

Further compounding the woes for Democrats, more than a third of Dems in the House of Representatives will come from just three states: California, Massachusetts, and New York — not helping their image as the new "party of the bi-coastal elites."

But while Republicans maintained their majorities in the House and Senate and sealed the win with a presidential cherry on top, the forecast for private equity is not as simple as it might seem. What should have been a clear path to GOP legislation has turned into situation a little more complex, as traditional Republican ideals (free trade, foreign policy) bump up against those of the new president.

> *"We're watching two civil wars right now — both with the Dems (Warren and Sanders vs. a centrist Bill Clinton/New Democratic party) and with the Republicans (the GOP base vs. the populist administration). The last six years will be nothing compared to the next two when it comes to this highly-partisan atmosphere."*

THE PRIVATE EQUITY EQUATION

So how does this affect private equity? That question is harder to answer than it might seem.

Factors *in Favor* of Private Equity:

- There have been Private equity-friendly appointments to President Trump's cabinet and advisory teams in Steve Schwarzman, Wilbur Ross, Steve Mnuchin and Gary Cohn, among others.
- President Trump has proposed corporate tax a rate of 15% — which would be very beneficial for the industry.
- A Republican House, Senate and President should equate to seamless, fast, business-friendly legislation.

Factors *Not in Favor* of Private Equity:

- Certain campaign promises were made. President Trump was vocal about "closing the carried interest loophole" during the campaign trail, appealing to a populist support base.

- Balancing the budget will be tough. Without the 60 votes needed from the Senate to pass a tax reform bill — with 52 Republicans, flipping 8 Dems is near-impossible — the bill will need to be budget-neutral. The estimated cost of the proposed corporate tax cut? $2.2 trillion.

- There is a lot to be done this year. With cabinet nominations and hearings, supreme court hearings and the small matter of the Obamacare "repeal and replace," the system can only handle so much in what will be a busy year for the House and the Senate.

"It will be 50% harder to pass business-friendly legislation in September than it would be in July. When Senators go back to their constituents during August recess, they often come back changed people. The most important commodity in Washington during the first seven months is Senate floor time."

There are a few key issues that the private equity industry, and its associated proponents in Washington, are focused on for the first year under the Trump Administration: carried interest, financial regulatory reform and interest deductibility.

The issue facing the biggest fight is around the carried interest tax provision. The scapegoating of the so-called "loophole" was broad during the primaries — from both parties — and it could provide another populist win for President Trump as he continues to look to make good on campaign pledges.

However, the taxation of carried interest as regular income rather than long-term capital gains would bring in an extra $17 billion over ten years — miniscule for a tax plan and just 0.77% of the $2.2 trillion needed to balance any potential tax reform bill — and House and Senate Republicans have broadly supported maintaining the status quo on the issue.

"The House and Senate have to think about what they would lose for $16 billion. Considering what this industry has brought to the American economy, the tax code should look more like carried interest, rather than getting rid of it. We should incentivize risk."

Financial regulatory reform will be unlikely to take place on the congressional level. Any regulatory reform will require 60 votes in the Senate and the likelihood of eight Democrats going against party lines is slim. This will make reform, such as repealing Dodd-Frank, difficult.

However, this may happen on the agency level at the SEC and others, where President Trump can exert more influence.

On the **interest deductibility** issue, the House may present a tax reform bill in 2017 that replaces interest deductibility with 100 percent expensing. Rather than a business being able to deduct interest payments from its taxable income, which encourages companies to use debt to expand — headcount, infrastructure, capital investments or other, limiting the deductibility of interest would limit how businesses fund growth.

The proposed alternative, 100 percent expensing, would provide a one-off tax deduction in capital expenditures, with a goal of encouraging investment in new assets. However, you can't expense what you can't afford. In other words, while this would benefit the relatively small set of larger companies that can afford to spend outright on investments, smaller companies who rely on debt financing — for expenses including working capital to cover bills, wages and weather cyclical sales cycles — would experience higher costs for borrowing in order to grow.

For private equity firms that employ debt at their portfolio companies, what happens with the interest deductibility vs. 100 percent expensing issue will shift how the industry uses debt moving forward.

[1] According to the nonpartisan Congressional Budget Office

THE WILD CARD

There is one thing that came up during our Roundtable that hasn't been mentioned yet: Twitter.

While careful work has been occurring to inform, educate and update the House and Senate on issues that affect the private equity industry and American business, there is a sense that all of this could be undone with 140 characters from the President's Twitter account if he refocuses his aim on the private equity world.

THE WAITING GAME

Although the industry has invested more than $600 billion in the U.S. economy in the past year alone — supporting 11 million jobs — and enjoys support from a Republican-led House and Senate, the early signs point to several unanswered questions for private equity.

At the pace things are unfolding over the first few weeks of the Trump administration, we'll likely have our answers to these questions sooner rather than later.

Will private equity gain or lose from the Trump administration? Let us know what you think. We'd love to continue the discussion.

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