BUDGET BATTLE LOOMS AS SUMMER WINDS DOWN

INTERNATIONAL TRADE VOLUMES RISING EVEN AMID PROTECTIONIST MEASURES

STEEL TARIFFS A POSSIBILITY AS PROTECTIONISM TAKES HOLD

PRIVATE EQUITY FIRMS: SELLERS’ MARKET CONTINUES
ABOUT THE AUTHORS

Our thought leaders are professionals with years of experience in their fields who strive to help you and your business succeed. Thought leaders who have contributed content to this issue include:

Joe Brusuelas, Chief Economist, RSM US LLP
Michael J. Grossman, Principal, RSM US LLP
# TABLE OF CONTENTS

- **Budget battle looms** as summer winds down .......................... 4
- **International trade volumes rising** even amid protectionist measures ............. 6
- **Steel tariffs a possibility** as protectionism takes hold ......................... 8
- Private equity firms: **Seller’s market continues** .............................. 10

This publication represents the views of the author(s), and does not necessarily represent the views of RSM. This publication does not constitute professional advice.
The Trump administration recently issued its annual midsession review of the budget. The indication is that the federal deficit will likely be about $100 billion larger than was anticipated as recently as May. The cause for this appears to be two-fold. First, economic growth this year has been softer than forecast by the Congressional Budget Office. Second, households and firms have priced in significant tax reform and therefore, likely put off the realization of capital gains and billing of services to take advantage of lower tax rates.

Given that the economy has entered the ninth year of recovery, the eighth year of economic expansion, and continues to grow at a sub-2 percent pace, there is a risk that falling revenue growth is signaling that the end of this business cycle could be approaching, especially if the widely-anticipated tax reform promised by policymakers doesn’t materialize.

In May, the administration’s budget indicated that the fiscal year 2017 deficit should be $603 billion—the difference between revenues of $3.46 trillion versus $4.062 trillion in outlays. About 60 days later, based on fresh information in the midsession review, the deficit is now anticipated to expand to $702 billion. While spending will total $4.045 trillion, a modest decline from the May estimate, revenues are expected to arrive 3.4 percent less than forecast or down $116 billion.

In the wake of the outcome of the 2016 election, businesses had a strong incentive to postpone profits and income to take advantage of lower tax rates. This has reduced federal tax collections and pushed forward economic activity, resulting in a temporary period of weaker than anticipated Treasury revenues. Thus, in our assessment, this may very well be a false indicator of possible recession during the next six months. Our recession indicator suggests a 15 percent probability of a recession in the near term. If that is true, and tax reform gets done, then policymakers should anticipate strong Treasury growth in the future.

Debt ceiling mechanics

While much ink has been spilled about the deteriorating budget outlook, we are far more concerned about systemic risk to the financial system linked to a debilitating debt ceiling battle. Despite the fact that the GOP has unified control of the federal government, the three factions that make up the party—Trump supporters, the Freedom Caucus and traditional Republicans—have yet to coalesce around an approach to lift the debt ceiling. Congress has until early October to lift the statutory upper limit on the borrowing authority of the federal government before the Treasury has to resort to extraordinary measures to keep essential areas of the U.S. government open and make interest payments on all past debt owed by the United States.

The term “extraordinary measures” refers to the halting of outlays in select areas of government operations to buy time for the Congress to lift the debt ceiling. While past episodes over lifting the debt ceiling haven’t resulted in the Treasury exhausting extraordinary measures and missing debt payments, if Congress doesn’t agree to lift the debt, it may very well create the conditions for a global systemic financial event. After the 2011 debt ceiling battle failed to produce an agreement, a credit rating agency downgraded the credit rating of the U.S. federal government. The General Accounting Office estimated that the 2011 game of chicken between the Obama Administration and Congress added an additional $1.3 billion to the national debt.
billion in borrowing costs to the federal government in fiscal 2011.

U.S. Treasury Secretary Steven Mnuchin has called for a clean debt ceiling decision, which means a simple lifting of the statutory rate without any concomitant reduction in overall spending. During the past several years, lifting the debt ceiling has become much more controversial as fiscally conservative members of Congress have refused to authorize it without reductions in other federal outlays.

After the recent failure of the Senate to arrive at a compromise on health care reform, middle market businesses that have revenue exposure to the federal government should be aware of the risks of a disruption. Moreover, given the relatively few days that Congress will be in session for the remainder of 2017, the window is rapidly closing on the opportunity to engage in tax reform or tax cuts this year. Based on the rules of the road in Washington, Congress and the administration must arrive at a fiscal 2018 budget and then lift the debt ceiling before they can use reconciliation to arrive at a tax cut or reform. If that doesn’t happen this year, and Congress only agrees to temporary funding at fiscal 2017 levels, that would push tax reductions and potential reform back into the calendar year 2018 with the midterm elections looming.

Based on our visits to Capitol Hill and with policymakers, we anticipate another round of debt ceiling roulette that will likely spill over into October. We wouldn’t be shocked to see a one- or two-week shutdown of the federal government before the GOP can come to internal agreement on the policy framework necessary to lift the debt ceiling.

**US Treasury federal budget net receipts individual income taxes**

![Graph showing US Treasury tax revenues (12-mo moving average) with quarterly periods from 2000 to 2017, indicating recessions with bars.](source: RSM, US Treasury)
A little noticed development amid increasing political rhetoric surrounding globalization and trade during the past year is that international trade volumes have notably improved, boosting production, employment and wages around the world and in the United States. During the past year U.S. exports of goods and services are up 5 percent as the ongoing global economic recovery shifts into second gear. Exports of industrial supplies and materials are up 14.7 percent, which is indicative of rising global demand.

After several years of modest improvement, global trade volumes are up 3.5 percent. The benchmark RWI Shipping Index, produced by the RWI–Leibniz Institute for Economic Research and the Institute of Shipping Economics and Logistics, is up 7.3 percent during the past 12 months. Like the recent improvement in U.S. trade volumes, the acceleration in overall global trade has been bolstered by trade in capital goods and industrial materials.

From a pure policy standpoint, a move toward the adoption of protectionist measures by the United States would be counterproductive and negatively impact the positive developments in the global economy after a long period of sluggish growth. In our estimation, global trade volumes will likely continue to expand and the imposition of tariff or nontariff barriers would result in higher prices for domestic U.S. producers who will bear what is essentially redistributive tax policies that favor a select number of producers at the expense of a large number of firms spread out among six major industry sectors.

One of the more encouraging aspects of the revival in the global economy has been increased volumes among the major developed economies. Global volumes are up 3.9 percent at a three-month average annualized pace, in contrast with the 2.2 percent average of the past three years. More importantly, both China and Japan are showing signs of growing demand, which will support an increase in commodity prices and provide a boost for emerging markets and energy producers like the United States.

Through May, Chinese exports have increased 15.7 percent, while imports jumped 22.3 percent on a year-ago basis. Japanese exports are up 12.2 percent and imports accelerated at a 15.4 percent increase on a year-ago basis. This has happened during a period when the yen appreciated in real terms by 10.2 percent and 14.4 percent in nominal terms, which points to underlying strength in the Japanese recovery.

The depreciation of the euro and British sterling has stimulated a strong increase in exports. European Monetary Union nations experienced a 5.5 percent increase in exports to economies outside the union, with Germany, Italy and Spain seeing close to 10 percent growth after five years of no growth in exports outside the economic union.

After the June 2016 Brexit vote, the U.K. has benefited from an 11.7 percent inflation-adjusted decline in sterling. Exports of U.K. goods have increased 12.9 percent, while imports are up 7.5 percent even given a rise in the price of imported goods linked to currency depreciation.
RWI Shipping Index

Source: RWI Institute of Shipping Economics & Logistics
STEEL TARIFFS A POSSIBILITY AS PROTECTIONISM TAKES HOLD

Would pose significant economic threat for middle market

By Joseph Brusuelas, Chief Economist, RSM US LLP

In April, the White House launched what is referred to as a “section 232” investigation to determine whether steel imports are a risk to U.S. national security. An affirmative determination resulting from the investigation would be rare. It would risk upsetting long-term trading relationships, slow the growth of the U.S. economy and likely induce retaliation from major U.S. trading partners thus causing prices to increase in other areas of the economy even unrelated to steel. Most importantly, the steel tariffs, if implemented, would result in an increase in prices, especially for middle market businesses that have elevated exposure to steel and ferroalloy products.

Activity to support domestic steel producers hasn’t resulted in success. The George W. Bush administration imposed tariffs of up to 20 percent on steel imports, which resulted in retaliation against the United States via the World Trade Organization that ruled that the action was illegal under existing treaty obligations. After that, the EU imposed $2.2 billion in retaliatory tariffs on the United States, which resulted in a withdrawal of the tariffs less than two years after they were imposed in 2002.

With the publication of the section 232 request likely to be released soon, it is important to note the different types of risk entailed in such a finding and the implications of potential tariffs on steel. First, it would be quite counterproductive if taxes were placed on all imports of steel. Roughly 36 percent of all steel imports come from Canada and Mexico, with Japan, Brazil and Korea representing 9 percent each. By category, steel products as percentage of total imports, are as follows: semi-finished products, 24 percent; long products, 21 percent; pipe and tube, 20 percent and flat products at 35 percent. Given the composition of imports and extremely low probability of geopolitical conflict with the aforementioned trade partners who represent roughly...
two-thirds of all steel imports does strongly suggest that such a move will do little more than redistribute wealth from large and middle market firms in an area of industries to the three major domestic producers of steel.

The security-based decision may be related to accusations of steel dumping by the Chinese into the United States. While China by far is the world’s largest steel producer—it is responsible for roughly 51 percent of total steel production, its total market share of U.S. imports is 3.3 percent. Therefore, these accusations on the surface appear to be factually incorrect.

While it is entirely understandable that the administration may want to renegotiate deals it feels need to be modernized, such as NAFTA, or to negotiate new trade deals that it feels promote fair trade, the current approach is likely to produce retaliation by the Chinese and the EU. Both countries are on the record stating they will retaliate if a section 232 request is operationalized.
Middle market sectors impacted: firms with high degree of exposure to steel inputs

- Industrial sub sectors
- Fabricated metal products
- Electrical equipment
- Appliances and components
- Machinery
- Transportation equipment
- Furniture and related products
M&A OUTLOOK: SELLERS’ MARKET CONTINUES

How can middle market private equity compete?

By Michael J. Grossman, Principal, RSM US LLP

How has the first half of 2017 shaped up in terms of dealmaking and mergers and acquisitions (M&A), and what will the second half bring? Michael J. Grossman, principal and national transaction advisory services leader for RSM US LLP, shares his thoughts.

What has the M&A climate been like in 2017 and what’s expected during the remainder of the year?

It’s been the same tune for the past several months; capital deployment remains a challenge. Despite record amounts of capital raising and overhang, valuations and heightened competition continue to constrain deal flow. It’s a sellers’ market now, and I think that will remain for the second half of 2017. Increased pricing and intensified competition among private equity firms chasing the best deals will likely continue into early 2018.

What factors have affected deal flow this year?

The domestic and global economies are relatively steady and this has likely given some sellers the confidence to value their businesses at a higher level. There’s plenty of capital out there to buy these businesses, and there’s fierce competition to go after those prime deals, private equity firms are getting out priced, unable to spend their growing capital. It’s a problem for some as they have to answer to their funding partners and have a limited time to deploy that cash. Some are getting outbid by strategic buyers, too, who are willing to pay even higher prices, and a long-term infrastructure build strategy.

For instance, a middle market private equity often looks for a business to invest in over a period of time, buying the business at a lower cost, developing the structure, operations and services over months and sometimes years, and then exiting at a later date when the business has matured and increased its value. It’s a more prolonged process. With these high valuations, discounted immature businesses with long-range promise aren’t there. Middle market private equity firms aren’t getting the deal choices they once had, and some are feeling that pinch.

In terms of deal flow, what industries have been hot this year and what’s cooled off?

The technology industry has continued to be hot and, likewise, technology within other industries has been upwardly trending, from fintech (technology in financial services) to technology in the automotive sector. It’s tech, tech, tech across the board. In addition, the consumer products industry has continued to see active deal flow, as well as the health care sector; however, there are some unknowns about how pending legislation may affect deals in the health care industry.

Meanwhile, business and professional services has been an active deal flow area in 2017 but we are not seeing the same level of growth lately.

What are sellers doing to appeal to buyers?

Some aren’t doing anything. They’re taking advantage of the high projected valuations and intense competition out there, hoping they’ll get the sale price they want without making business improvements. Unfortunately, this is affecting the overall quality of deals in some cases. Our guidance to them is make yourself more appealing to buyers. It’s to your advantage. Improve your systems and technologies, complete sell-side due diligence so you’re positioned optimally for the sale, demonstrate your growth to potential buyers and invest in getting the right infrastructure in place. In the long run, all of this will provide more value to you when you get ready to sell.

Just like a freshly remodeled home with an open floor plan, economy-saving heating and cooling and new roof would sell for more than a home that’s not been updated since the 1980s, so too would a business with a solid operating structure, updated technology systems and credible financials be more appealing to eager buyers.

In this highly competitive market, how are some middle market private equity buyers differentiating themselves with sellers?

Buyers are looking for the right price, the right terms, the right businesses for growth, the right people and the right fit for their portfolios. And for some private equity firms, particularly those in the middle market space, fit means focusing on a particular industry. More and more we’re seeing industry-specific private equity firms that have built a focus on one or two industries to really hone in on best practices related to that industry, industry contacts, operations and more. Having this deeper dive in a specific industry to invest in means buyers can leverage industry-centric knowledge to develop the businesses they acquire, thus differentiating themselves among the other more generalist buyer competition. In addition, being in the same industry as the seller, speaking the same language and knowing the industry nuances establishes goodwill and trust with the seller. You’re part of their community. You know them and you have a passion for their business. In these competitive times, that could be the X factor a middle market private equity needs to land the deal.

And once you’ve found that potentially right fit, buy-side due diligence can help reveal risks and opportunities so the private equity firm can make an informed decision about how and whether to proceed. Assessing earnings and cash flow quality, analyzing assets and liabilities, evaluating working capital, identifying internal control weaknesses, reviewing the purchase agreement and more are all key to assuring a solid transaction—especially during these competitive times.

For more dealmaking insights, M&A trends and economic implications, check out our Quarterly Industry Spotlights.