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Jim Tumulty Principal & CEO
(W) 412-756-0068; (C) 732-539-8421
jtumulty@calibregroupllc.com

Ed Siegel Principal & CFO
(W) 412-756-0069; (C) 732-284-8156
esiegel@calibregroupllc.com

Toby Kreidler Principal
(W) 412-756-0063; (C) 412-417-8563
tkreidler@calibregroupllc.com

Jeremy Breazzano Principal
(W) 412-756-0066; (C) 508-479-8018
jbreazzano@calibregroupllc.com

Michael Rotch Vice President
(W) 412-756-0064; (C) 614-288-0344
mrotch@calibregroupllc.com

CALIBRE GROUP

Destination-Based Taxes – The Sneaky Tariff

Proposed border-adjustment taxes could lead to structural long-lasting tariffs

SUMMARY

There has been a lot of rhetoric out of Washington about tariffs, tax cuts, loosening regulations, infrastructure spending and other buy-America, pro-manufacturing policies over the past few months. The Trump administration proposed to boost growth to 4% and to create millions of jobs. What gets lost in a lot of the hype are actual policy specifics. One issue that is receiving attention, but is largely overshadowed by the catchier news about wall building and immigration, is the idea of a destination-based tax (or border-adjustment territorial tax). This scheme was proposed by Republican Congressional leaders, and given their control of the House, Senate and White House, its likelihood of getting approved is higher than ever before. If passed, it could have a tremendous impact on the steel industry, both positively and negatively depending on your customers, suppliers, and certain other factors.

WHAT IS A DESTINATION-BASED TAX

Under the proposed destination-based tax, companies would be taxed based on where they sell their goods, regardless of where production, management or income is located. Essentially the way the proposed tax works is that it taxes imports and exempts exports from being taxed. To see how this would work we included an example in the right-hand table. There are three hypothetical companies. BaseCo is a domestic company that has all of its sales and costs occurring in the US, it does not export or import any products. All else equal, as shown the destination-based tax has no direct impact on BaseCo. ExporterCo purchases all of its material within the US, but

Destination-Based Tax Example

($ in Millions)	BaseCo	ExporterCo	ImporterCo
Revenue Domestic	$100	$30	$100
Revenue Export	$0	$70	$0
Total Revenue	$100	$100	$100
Inventory Sold - Cost Of Domestic Material	$40	$40	$10
Inventory Sold - Cost Of Imported Material	$0	$0	$30
Total Inventory Sold	$40	$40	$40
Pre-Tax Income	$60	$60	$60
Taxable Income - Based On Destination-Based System	$60	($10)	$90
Tax Rate	20.0%	20.0%	20.0%
Taxes Paid Current System	$12	$12	$12
Taxes Paid - Destination-Based System	$12	($2)	$18
Net Exporter / (Importer)	$0	$70	($30)
Tax Savings / (Costs)	$0	$14	($6)

70% of its revenues comes from exports. All else equal, ExporterCo will save $14 ($70 in export revenue times the 20% tax rate) in tax expense from switching from the current tax system to the destination-based tax system. ImporterCo imports 75% of its material costs, and doesn't have any export revenue. All else equal, ImporterCo will have to pay an incremental $6 ($30 in import material cost times the 20% tax rate) in taxes from switching from the current tax system to the destination-based tax system.

STRUCTURAL ALL ENCOMPASSING DE FACTO TARIFF

Ultimately, the tax policy effectively creates a structural tariff. For instance, any product that is imported gets $0 value for costs for tax purposes and no deductibility, and any product purchased domestically gets the full tax deduction. The new tax proposal comes with a provision to lower corporate tax rates to 20%. That means the destination-based tax proposal is a de facto 20% tariff on all imports. It also implicitly subsidizes exports by making revenue from them tax-free in the US.

This encourages customers to buy America. A car manufacturer that has the option to import a part for $100 or purchase it from a domestic supplier for $115, would be economically incentivized to purchase the part from the domestic supplier. The after-tax cost of purchasing from the domestic supplier is $92 ($115 minus the tax savings of $23), whereas the after-tax cost of purchasing from the importer is $100.

In addition, unlike a trade case or a tariff targeted against a specific country, this creates an implicit tariff against all countries for all goods and services. It doesn't matter if you import product from Germany or China, there is no tax-deductibility of the costs in either case.

TRADE WAR?

If the US government decides to impose a direct tariff, instead of this destination-based tax, it would never hold up at the World Trade Organization ("WTO"), and would almost certainly lead to a trade war, with other countries imposing tariffs on US products. While there are certain nuances that might make the WTO rule against the proposed destination-based tax, most agree that it would be less likely to lead to trade wars. Part of the reason is that most of the developed world already has territorial tax systems, whereby taxes aren't paid on exports, and imports are not tax deductible. So, the US shifting to a destination-based tax would just make it more in-line with the rest of the world. The one major difference between other country's systems and the proposed US plan, is that other countries use their territorial tax as part of VAT (value-added tax) systems. Since the US is not proposing to shift from an income to a VAT tax, it is still possible that the WTO rules against the US plan.

IMPACT OF A DESTINATION TAX

If the US were to implement this tax, exports would become more competitive, because by not paying US income tax on that revenue, companies would be able to lower prices on international sales. Imports into the US would become less competitive, as the cost would be 20% higher (or whatever the income tax rate ultimately is at a given time) than domestically sourced goods. These two factors would help lead to a reduction in the US trade deficit.

Industries that import a lot of their material costs, such as the retail industry, are lobbying very hard against this tax proposal. For many companies within the steel industry this tax may have a significant impact. Across all steel mill products in the last three years (2014-2016) the US imported 40, 35 and 30 million metric tonnes, respectively. In dollar values that was $38 billion, $30 billion and $22 billion, respectively.[1] Based on a 20% corporate tax rate, that would be an implied annual aggregate cost of $7.6 billion, $6.0 billion and $4.4 billion, respectively to those companies that purchased imports.

The US currently cannot produce enough steel to meet demand. While some companies that currently import steel may buy higher priced domestic material, others will be forced to continue to import given the lack of production capacity. This tax may adversely affect those companies from a cost perspective.

Additionally, certain other operating costs, such as costs associated with the consumption of refined petroleum products (electricity, etc.) would likely be higher as refineries would push higher costs through to end users (costs would be higher as refineries that import oil would not get any tax benefit).

On the demand side, many service centers should benefit from increased demand for their domestic product. For example, take a look at the automotive industry. In 2016 there were approximately 17.5 million vehicles sold in the US. However, only about two-thirds of vehicles sold were produced in the US. Additionally, even the vehicles produced in the US have significant amount of parts imported. In 2016 there were $350 billion of automotive vehicles and parts imported into the US.[2] Given the magnitude, even a small shift in production to the US, or purchase of more parts from US suppliers, could have a large positive impact on demand for metals companies.

We caution that the impact of such a move may not have as profound an affect as many may think. As some economists point out, this policy could lead to a substantial strengthening of the US dollar, which would make imports cheaper on a US dollar denominated basis. This would help mitigate the incremental cost associated with importing products, but also mitigate the advantage domestic companies could have over foreign competitors.

Empirically when Japan shifted from a worldwide tax system (which the US currently has) to a territorial tax system in 2009, its trade surplus increased. The Japanese trade surplus in 2010 was the highest it had been since 2006.[3] However, after 2010, Japan ran annual trade deficits. The problem with measuring the impact is that there are many variables that impact trade deficits, such as domestic factors in other countries, prices of natural commodities (Japan is heavily reliant on imported oil, so as oil prices rise trade deficits will get worse, regardless). It is difficult to point to one specific policy and determine empirically exactly what its impact is. That is why it is important to look logically at the impact one assumes such a tax would have.

Another less talked about effect of this proposal is that it will likely lead many of the companies that currently have cash parked overseas at foreign subsidiaries to bring that cash back home, as it may not be subject to a deferred tax any more. This could have a positive effect on capital spending in the US as it is estimated that US companies have $2.5 trillion of cash being held overseas.[4]

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[1] US Department of Commerce.
[2] United States Census Bureau (https://www.census.gov/foreign-trade/statistics/historical/SAIMP.pdf).
[3] Bloomberg.
[4] CNBC.

IN CLOSING

It is safe to say that if the proposed destination-based tax gets passed there will be an immediate positive impact for companies that don't rely on imports, and compete for customers against foreign competitors.

For companies that currently purchase materials from importers, you may consider expanding your supplier base domestically. There is less steel capacity in the US than demand, so companies not purchasing from domestic suppliers at the time this law gets enacted may be stuck paying the 20% penalty…but don't worry too much, we are talking about Washington and nothing ever gets done fast.

CALIBRE SELECT INVESTMENT BANKING TRANSACTIONS

Greenfield Capital Raise for OCTG Producer Greenfield OCTG Producer Ongoing	Greenfield Capital Raise for Steel Bar Producer Greenfield Steel Bar Producer Ongoing	Chief Restructuring Officer Strategic Consultant HI-TEMP SPECIALTY METALS INC May 2016 – January 2017	Advisor on Acquisition Metal Processor December 2016	Strategic Consultant Pennsylvania Scrap Processor February – April 2016	Investment Banking Services Heidtman Steel March 2016	Advisor on Strategic Projects for the Company COLT DEFENSE November 2014 – February 2015
Advisor to the Debtor Sale of Assets Chapter 11 363 Sale ORMET July 2014	Advisor to the Seller Mountain States Carbon, LLC June 2014	Labor Advisor to Debtor ORMET December 2013	Advised Aurora Capital On the sale of Miami Valley Steel Service July 2013	Advised Official Unsecured Creditors Committee Chapter 11 LYON Workspace Products April 2013	Advised Debtor Sale of Assets Chapter 11 363 Sale RG STEEL, LLC August 2012	Advised PE Sponsor Sale of Company & Subsidiary Spin-off New Star Metals August 2012
$1,200,000,000 Advised Seller on Sale of Assets to RG Steel Severstal March 2011	Advised Seller NSG Has been Acquired by AURORA RESURGENCE June 2010	Advised Buyer ESMARK Has been Acquired by Severstal August 2008	Advised Buyer WCI STEEL Has been Acquired by Severstal May 2008	$110,000,000 Short-term Financing ESMARK April 2008	$200,000,000 Capital Raise for Merger ESMARK November 2007	$39,000,000 Acquisition Capital ASI August 2007
$46,500,000 Convertible Debt Raise FRONTERA RESOURCES May 2007	Advised Buyer Independent Steel Has been Acquired by ESMARK August 2006	$50,000,000 Term B Financing WS WINNER STEEL, INC March 2006	Advised Buyer PRG PREMIER RESOURCE GROUP Has been Acquired by ESMARK January 2006	$125,000,000 Refinancing Marcal December 2005	Advised Buyer North American Steel Has been Acquired by ESMARK December 2005	$140,000,000 Acquisition Capital Sheffield STEEL PRODUCTS, INC. July 2005
Advised Buyer Miami Valley Steel Service Has been Acquired by ESMARK May 2005	Advised Buyer US Metal & Supply Has been Acquired by ESMARK March 2005	Advised Buyer TriWestern Metal Has been Acquired by ESMARK January 2005	Advised Buyer Century Steel Has been Acquired by ESMARK January 2005	$1,100,000,000 Acquisition Capital Severstal December 2004	$125,000,000 Financing AMD FUJITSU December 2004	

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