OBSERVATION
TD Economics

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HOW HEALTHY ARE CANADIAN CORPORATE BALANCE SHEETS?

Highlights

- Business investment has been missing in action in the recent acceleration in Canada's economic growth. The Bank of Canada has highlighted that healthy corporate balance sheets as a positive foundation for the next leg up in capital spending in Canada. How healthy are the corporate balance sheets?
- After a rough patch in 2012-13, corporate balance sheets are expanding again, and liquidity has improved. Much of that liquidity is being held as cash, suggesting corporations are well placed to invest once opportunities arise, or can weather an unexpected bout of volatility. However, much like growth in the broader economy asset performance is not what it was pre-recession.
- Corporations have hinted at a willingness to invest by ramping up borrowing activity in recent quarters, primarily through increased bond issuance. All of these trends suggest that businesses have the capacity to invest, once they are more confident about profitable opportunities.

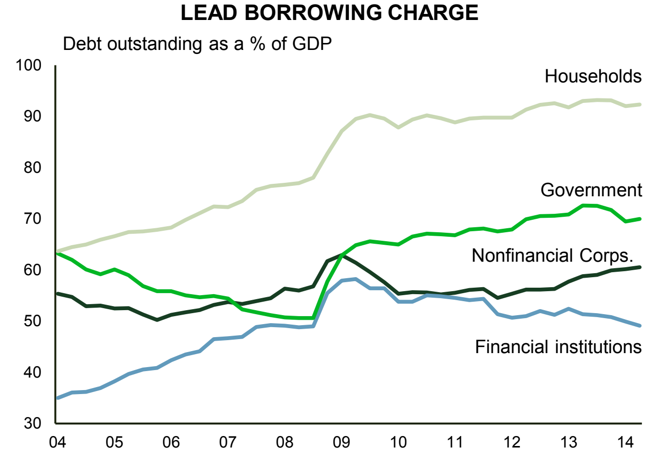
Economists and policy makers in Canada have forecast that stronger business investment will help lift Canada's economic growth higher over the next couple of years. So far, the expansion in capital spending has not materialized. One necessary condition for this to occur is strong corporate balance sheets, which would enable companies to finance investment. In its recent Monetary Policy Report, the Bank of Canada highlighted the "healthy" state of corporate balance sheets. This raises the questions: how healthy are the balance sheets of nonfinancial corporate businesses? Is this health widespread across industries?

The necessity for business investment to pick up comes from the fact that since the recession, governments and households had built up high and rising debt loads and no longer have the financial wherewithal to drive economic growth to the same extent. Meanwhile, Canada's nonfinancial corporations' debt levels held relatively steady as a share of GDP (Chart 1). More recently, the tables have turned and nonfinancial businesses have increased their borrowing.

Looking at financial flows for the economy as a whole, nonfinancial corporations in Canada were "net lenders" to the rest of the economy from 2000-2012. Over the past couple of years, however, that has shifted and they have become net borrowers within Canada's economy.

Overall Canada's nonfinancial corporate balance sheets are expanding again as corporate profits have started to recover from their 2012 slump (see Chart 2). Looking ahead, stronger global growth is expected to contribute to continued growth in corporate profits, which should improve businesses capacity to invest.

CHART 1. NONFINANCIAL CORPORATIONS LEAD BORROWING CHARGE



Source: Statistics Canada

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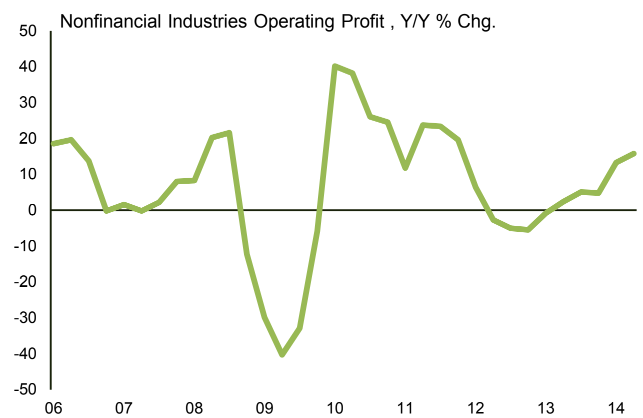
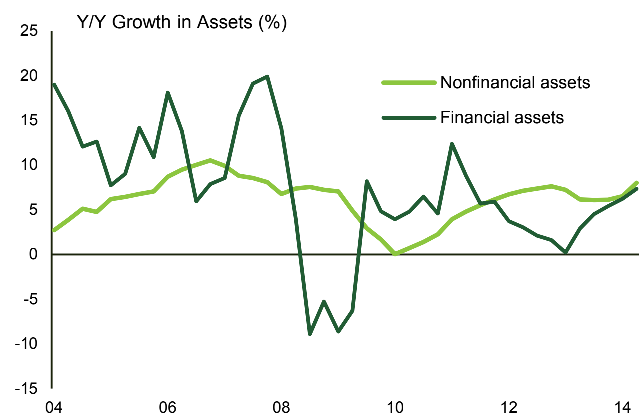
CHART 2. CORPORATE PROFITS RECOVERING



Source: Statistics Canada, Quarterly Financial Statistics for Enterprises

CHART 3. BETTER ASSET GROWTH



Source: Statistics Canada, National Balance Sheet Accounts (market value)

Moreover, Canadian businesses have notably increased their cash holdings in recent quarters, suggesting they are well placed to either weather any unanticipated revenue volatility, or invest once profitable opportunities arise.

Equity markets have already recognized Canada's improving corporate fortunes. After two years of going nowhere, the TSX has been rallying since the second half of last year. Investors often look to "strong" balance sheets as an important consideration before investing in a company's stock. But how do we measure the strength of a balance sheet? To get some answers, an economist will put on an accountant's hat.

What is a strong balance sheet?

Assets on nonfinancial private corporations' balance sheets rebounded strongly from the recession. However, they faltered in 2012, led by a dramatic drop in the pace of financial asset accumulation as corporate profits sunk(see Chart 3). More recently, as profit growth has picked up, financial assets are helping to drive balance sheet expansion once again.

However, much like more modest growth in the broader economy, asset expansion has also slowed relative to its pre-recession pace. Since the recession, assets have grown at an average of 5% year-on-year. Over the same time period pre-recession, assets were advancing at twice that pace.

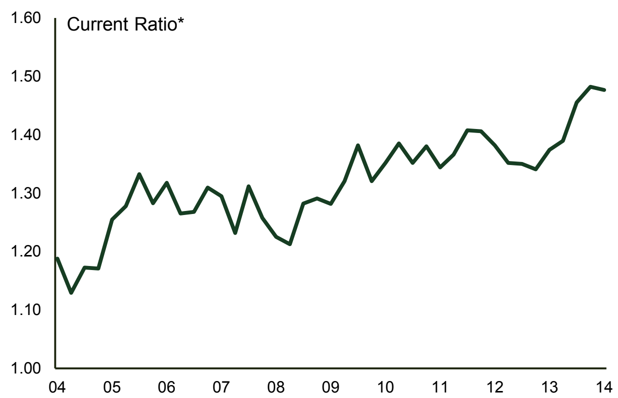
The moderation in asset growth reveals little about recent changes in the underlying health of balance sheets. A more important consideration is how the various components are performing relative to one another. There are three broad categories of balance sheet strength: liquidity, asset performance and capital structure. Looking at each category in turn, how do Canadian nonfinancial firms measure up?

Liquidity refers to how comfortably a company can meet its short-term financial obligations. Sometimes referred to as "working capital", it can be measured as current assets minus current liabilities. If a business's current assets don't exceed its current liabilities it may have trouble paying its creditors in the short term. Positive working capital is required to ensure a company can continue its operations and has sufficient funds to meet maturing short-term debt obligations and upcoming operational expenses. However, too much working capital isn't necessarily a good thing either; it could indicate a business has too much inventory or excess cash.

When analysts look at liquidity, it is typically measured by a ratio of short-term assets to short-term liabilities, known as the current ratio[1]. Nonfinancial firms have seen a long-term up trend in their liquidity (see Chart 4), and this trend is the same in most countries. Research from the Bank of Canada suggests that this long-term trend could in part be explained by the growing role of services industries in the world economy[2]. Service industries are often more reliant on short-term investments as opposed to large long-term investments, and thus a growing services sector could imply an upward trend in the corporate sector current ratio.

Turning to more recent trends, liquidity remained relatively flat over the 2010-12 period. But, it has picked up notably over the past year in line with improving corporate profits. This has driven an improvement in the growth in current assets, while the pace of current liabilities has remained fairly steady. The most rapid buildup in current

CHART 4. LIQUIDITY HAS IMPROVED



Source: Statistics Canada, Nat. Bal. Sheet Accts for Private Nonfinancial Corps.
Current Ratio = short-term assets/short-term liabilities

assets has been for cash, and this has led to much speculation in the business media about corporations in Canada sitting on mountains of cash and not investing. Canadian nonfinancial corporations currently have $646 billion dollars on their balance sheets as of the second quarter, roughly 12% of total assets.

The increase in cash on balance sheets has been a long-term phenomenon. In part, this reflects a substitution away from other short-term financial assets as the longer-term decline in interest rates makes investing in short-term investments less attractive (see Chart 5). This has particularly been the case in recent quarters, as financial assets as a whole have not increased on the balance sheet, which cash has. This suggests that cash is likely substituting for other financial assets.

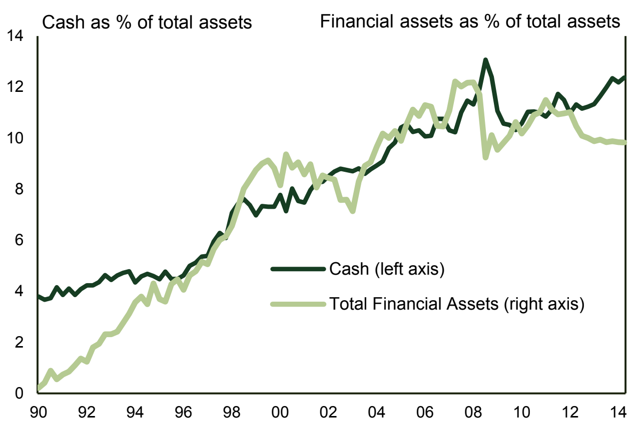
Moreover, there are many reasons a firm would hold cash, including being financially constrained. Cash holdings would allow constrained firms to continue operations and pursue investment opportunities when they are unable to obtain capital. Research from the Bank of Canada[3] suggests that the increase in cash holdings of Canadian firms from 1980-2006 was due to the following changes in firm characteristics: increased number of firms who were financially distressed, cash-flow variability, expenditure on R&D, a decrease in firm size, and the use of cash substitutes. Their analysis suggests that firms are holding more cash because their characteristics have changed, rather than some change in aggregate firm demand for cash, such as hoarding due to increased risk aversion.

It is also revealing to see if key sectors in Canada have seen a rise in cash balances. To examine liquidity by industry, like manufacturing, resources, retail, construction and utilities, we look at a different data set from Canada's Quarterly Financial statistics for enterprises. Due to data constraints at the industry level, we focus on a more simplistic measure of liquidity – cash to total liabilities. For non-financial corporations as a whole it this data set, the cash ratio has been flat over the past year, but the resource (includes agriculture, forestry, oil and gas, and mining) and manufacturing sectors have seen a deterioration in their cash position recently, while the retail sector has seen a clear upward trend (see Chart 6).

How are assets performing?

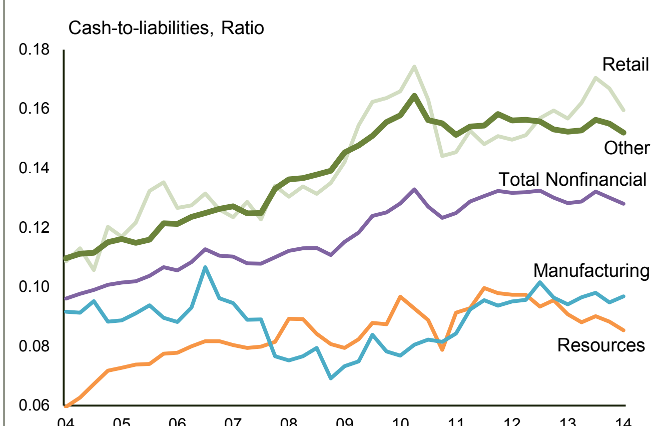
While liquidity is important, a strong asset performance is typically a criterion for whether a firm is a good invest-

CHART 5. CASH SUBSTITUTE FOR OTHER FINANCIAL ASSETS



Source: Statistics Canada

CHART 6. CASH RATIO



Source: Statistics Canada

ment. One metric is the return on assets (ROA), which is generally considered to be a profitability ratio. It divides net income (or in this case operating profits) by total assets. For Canadian nonfinancial corporations, return on assets improved in the wake of the recession, but then declined in 2012 during Canada's corporate profit slump (see Chart 7). The ratio has started to improve modestly since. However, it is below the average level that prevailed prior to the recession, mirroring trends in economic growth and the level of interest rates. (Everything is below its pre-recession rate.)

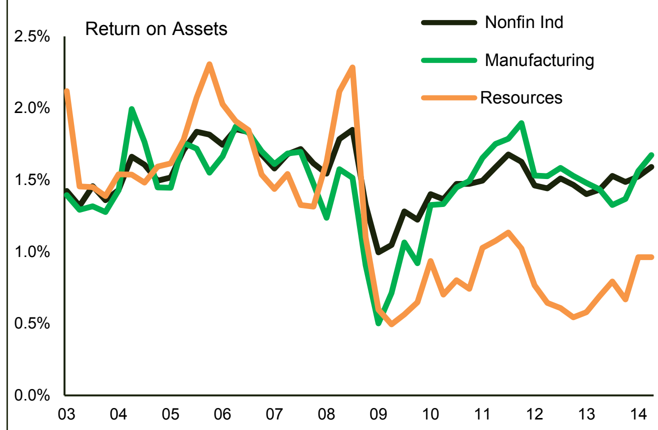
A separate measure investors often look at is return on equity (ROE), which is similar to ROA, but the denominator is shareholders' equity. By that measure, Canadian nonfinancial firms are performing a little better relative to history. The main difference between ROA and ROE is financial leverage. The fact that ROE is doing a bit better than ROA for Canadian firms reflects the increased leverage in recent years. Debt amplifies ROE relative to ROA

The performance of assets since the recession underscores some of the challenges non-financial corporations in Canada have faced in recent years. Disappointing global growth, weakness in many commodity prices and an increasingly modest domestic demand backdrop have all weighed on revenues.

Looking under the hood on return on assets, while the nonfinancial corporate sector has been fairly flat since the recession, certain key industries have seen their ROA deteriorate[4]. The resource sector, and more specifically the mining and oil and gas sector's ROA, is much lower than its pre-recession performance (see Chart 8). This largely reflects steep declines in operating profits in 2012 and early 2013 as commodity prices fell. More recently, the profit backdrop has started to pick up, and there has been an up trend in ROA of the resource sector, however, the overall level remains well below the pre-recession average.

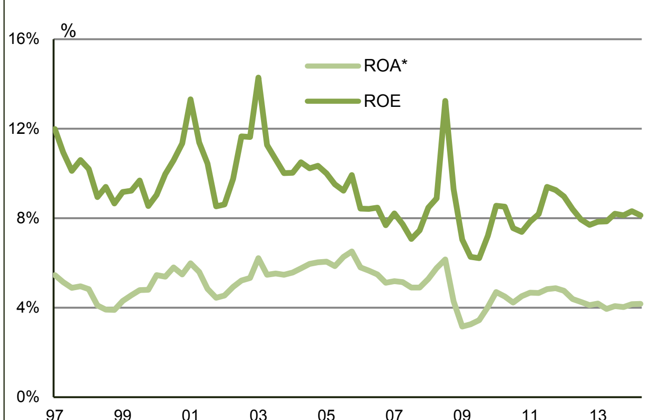
Finally, the capital structure is how a firm finances its overall operations and growth by using different sources of funds. Most commonly, analysts look at debt-to-equity ratios, and are typically looking for how heavily debt-financed a company is, or the level of leverage which can increase the riskiness of a given firm. Higher leverage implies that debt-servicing costs would be higher and make a company riskier in the event of a dip in revenues. After a long-term decline in leverage, Canadian nonfinancial firms have seen their degree of leverage rise in recent years (see Chart 9). With overall leverage remaining low by historical standards,

CHART 8. RETURN ON ASSETS



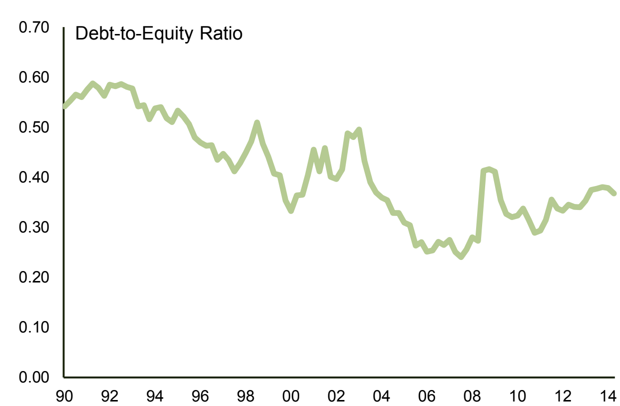
Source: Statistics Canada, Quarterly Financial Statistics for Enterprises

CHART 7. RETURN ON ASSETS & EQUITY

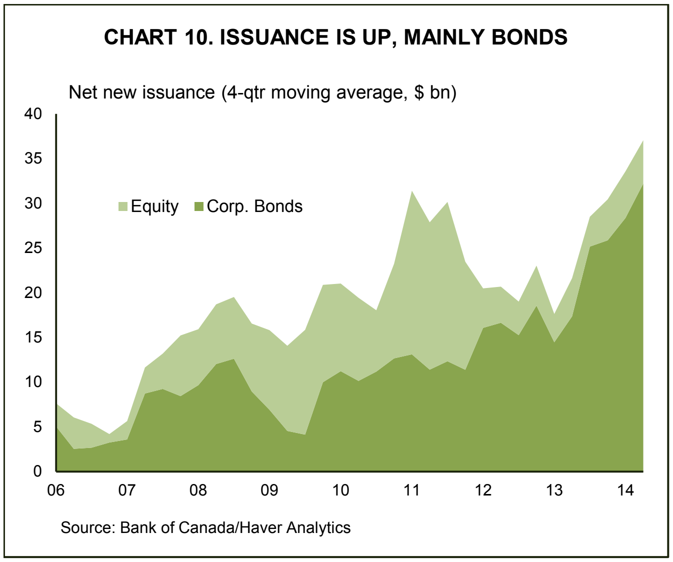


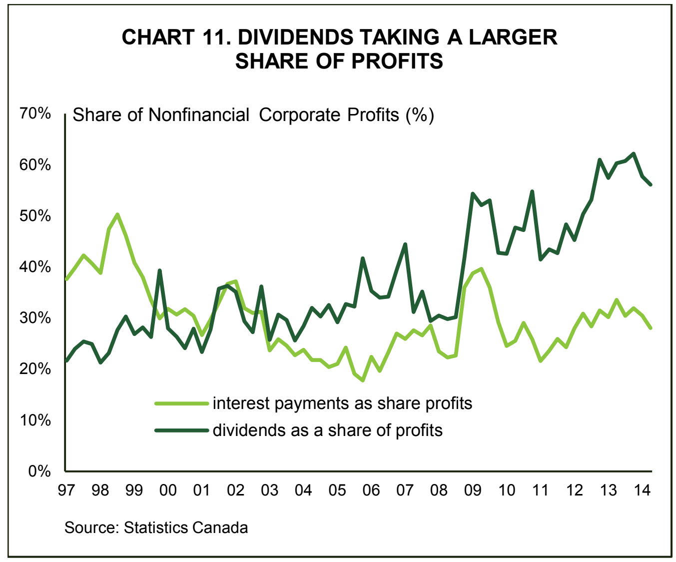
Source: Statistics Canada, National Balance Sheet Accounts
* *Net Operating Suplus/ Total Assets*

CHART 9. LEVERAGE HAS INCREASED



Source: Statistics Canada, Nat. Bal. Sheet Accts for Private Nonfinancial Corps.
Debt-to-equity = (total loans + issued debt)/equity





this can be viewed as a positive indication that businesses are borrowing to invest.

To examine leverage by industry the quarterly financial statistics for enterprises data set is used. It does not show an increase in leverage for nonfinancial corporations as a whole, however there has been a pick up in recent years in a few industries. The most notable increase was in information and cultural industries, followed by the mining sector and retail trade industries.

Net new issuance of corporate bonds has also risen steadily since the recession. Companies have taken advantage of very low bond yields and a narrowing in corporate spreads over the past couple of years. In part, this represents an increased preference for debt versus equity financing. But, it is not a pure substitution – overall net issuance is still increasing (see Chart 10). This might suggest that businesses are gearing up to invest.

Is this increased borrowing or the degree of leverage a cause for concern? Much as we look to debt service ratios for households as a gauge for how onerous debt loads are, we can do the same for nonfinancial corporations. Borrowing is effective for growing a business, but it is not free, and the burden of interest payments can be measured by the proportion of operating profits accounted for by interest expense. Interest costs as a share of operating profits has been trending up over the past several years, but remains below its late-1990s levels (see Chart 11). It is dividends' share of profits that has risen much more dramatically in recent years, in line with market demand for income in a low interest rate environment. The rising burden of dividend payments may also help explain why Canadian companies have had an overwhelming preference for issuing bonds rather than equity when going to market for financing in recent years.

The Bottom Line

Overall, despite facing a challenging profit environment in recent years, nonfinancial corporate balance sheets are in solid shape. However, much like growth in the overall economy, which is not as strong as it was before the recession, return on assets has also been less robust than it was before the recession. Fortunately, there are early signs of improvement. Corporate profits are recovering, and balance sheet expansion has already started to improve.

Over the next couple of years corporate profits are expected to grow at a solid mid-single digit pace, helping assets to continue to progress and strengthen corporate balance sheet positions overall. The recent increase in liquidity could also indicate that businesses may be poised to invest, having recently increased their borrowing. We would expect to see much of these cash balances put to work in the coming quarters the acceleration in the U.S. economy helps lift growth in Canada, and businesses are eventually confident enough to invest in expansion once again.

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End Notes

1. Methodology was followed as in Bank of Canada Working Paper 2007-24 "Corporate Balance Sheets in Developed Economies: Implications for Investment". http://www.bankofcanada.ca/2007/03/working-paper-2007-24/
2. Bank of Canada Working Paper 2007-24. Denise Côté and Christopher Graham "Corporate Balance Sheets in Developed Economies: Implications for Investment".
3. Bank of Canada Discussion Paper 2008-16. Darcey McVanel and Nikita Perevalov "Financial Constraints and the Cash-Holding Behaviour of Canadian Firms".
4. The industry level data refers to Statistics Canada's Quarterly Financial Statistics for Enterprises, so the NonFinancial total in the chart will not match the previous total.