TD Economics

Topic Paper

April 28, 2005

CANADIAN CORPORATIONS ARE RIDING THE PROFIT SURGE

The story of Canadian corporate profits rising sharply following the economic slowdown and stock market correction of 2001 is well known. In case you missed it, corporate profits as a share of national income hit a record level in 2004. But, this only begins to scratch the surface on the true health of Corporate Canada, as a closer look into balance sheets reveals that most non-financial corporations, regardless of industry, are less leveraged and more liquid than any other time in recent history. In addition, a series of global shocks – Asian flu (1997/1998), tech wreck (2000), terrorist attacks (2001), unprecedented rise in Canadian dollar (2003+) – alongside a higher order of domestic and international competitiveness have encouraged firms to keep a tight lid on costs, even when profits soar. All this translates into record retained earnings, including the manufacturing sector, which is typically thought to be the most vulnerable to the near-30 per cent rise in the value of the Canadian dollar since the beginning of 2003.

Corporations cannot simply build up savings in perpetuity, as it can be detrimental to underlying profitability if business strategies are too conservative or fail to realize a firm's potential – especially in a globally competitive market place such as today. But, healthy corporate balance sheets do leave firms with a significant degree of flexibility to adjust to shocks and to absorb risk in implementing corporate strategies. In fact, Canadian firms are already going down this road, as estimates for 2004 show a 39 per cent increase in the value of merger and acquisition (M&A) deals. In all probability, M&A activity will remain a top consideration for many Canadian companies in 2005, but we may also begin to see more in the way of dividend payouts and productivity enhancing investment initiatives, which, so far, have underperformed profit growth. That said, there will be some headwinds, including an expected slowdown in profit growth, ongoing global financial risks and the possibility of a pull back in commodity prices.

Looking beneath the surface

The scars of the economic slowdown and stock market correction in 2001 have long faded from corporate bottom lines and pre-tax profits have since risen by an average annual pace of 12 per cent. And, while the balance sheets of non-financial firms have been undergoing a longer-term trend improvement, the process has accelerated more recently. This is particularly evident in tradi-

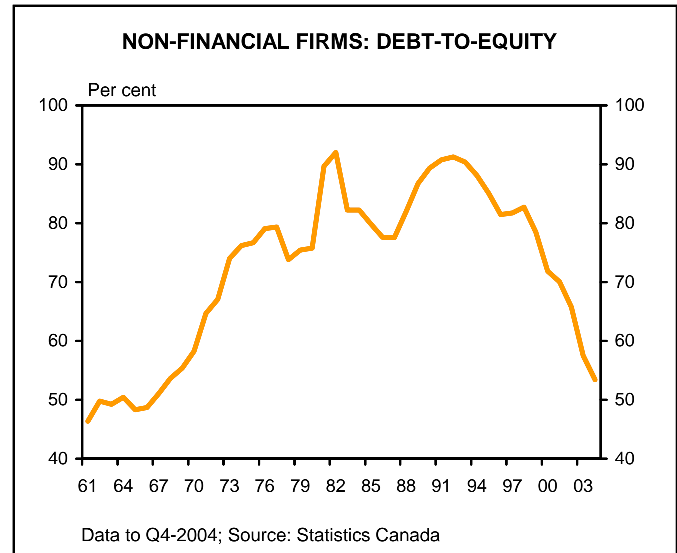
tional ratios of liquidity and corporate vulnerability – such as liquid assets-to-short-term liabilities and debt-to-equity. Liquidity has been rising since the mid-1990s, but a sharp improvement occurred over the 2002-to-2004 period. Similarly, a downtrend in the debt-to-equity ratio left it at a 35-year low in 2004.

Negotiable debt playing second string to share issuance

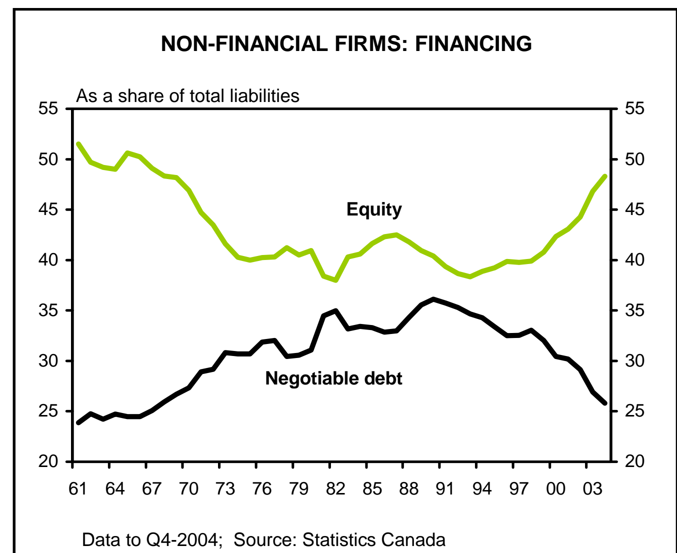
The quick explanation is that the strong rebound in profits has enabled firms to shore up balance sheets more aggressively. But this is only a partial answer, as there are distinctive shifts occurring within the financial asset and liability categories. Specifically, the debt-to-equity ratio has fallen as firms increasingly shift away from debt funding sources towards equity issuance. Negotiable debt – defined as loans, bonds, short-term instruments and mortgages – relative to total liabilities hit a 35-year low in 2004. The liability structure among non-financial firms was already moving in this direction long before this, but the process accelerated over the 2002-to-2004 period due to unusually flat growth in negotiable debt. No doubt, high cash flow would have reduced the need to raise funds through debt markets. But even so, equity issuances never lost favour as a funding source and the combined impact caused equities to make up nearly 50 per cent of total corporate financing needs and other liabilities. In effect, firms have shifted a greater amount of their risk structure into the hands of individual stakeholders.

Cautiousness evident by high cash holding

On the asset side of the ledger sheet, non-financial firms beefed up their holdings of cash and deposits. Since 2001, this asset class has been rising at an average annual pace of 15 per cent. In addition, a substantial amount of the accumulation in deposits over the past three years has been in foreign deposits. This happens to coincide with the unprecedented rise in the value of the Canadian dollar, suggesting that firms may have been caught off-guard and opted to "park" the cash in foreign deposits in anticipation of future ventures or in the hopes of some unwinding of currency strength, rather than incur exchange rate losses through repatriation. Regardless of the explanation, the increase in the cash position of firms has left them very liquid relative to past years.



Data to Q4-2004; Source: Statistics Canada



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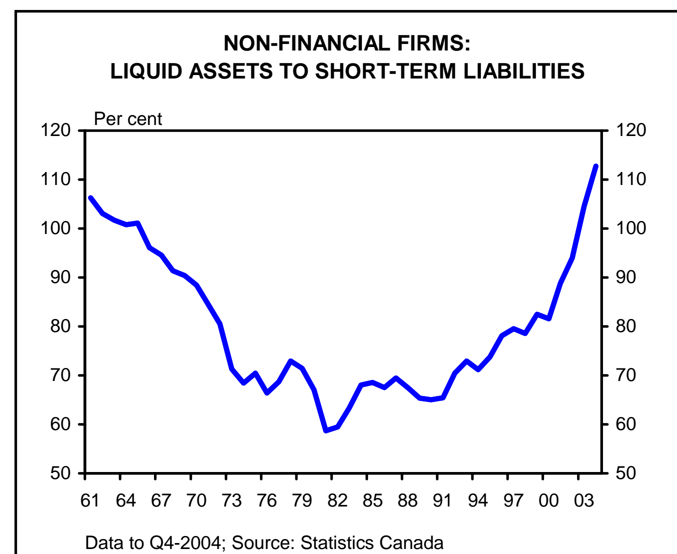


Data to Q4-2004; Source: Statistics Canada

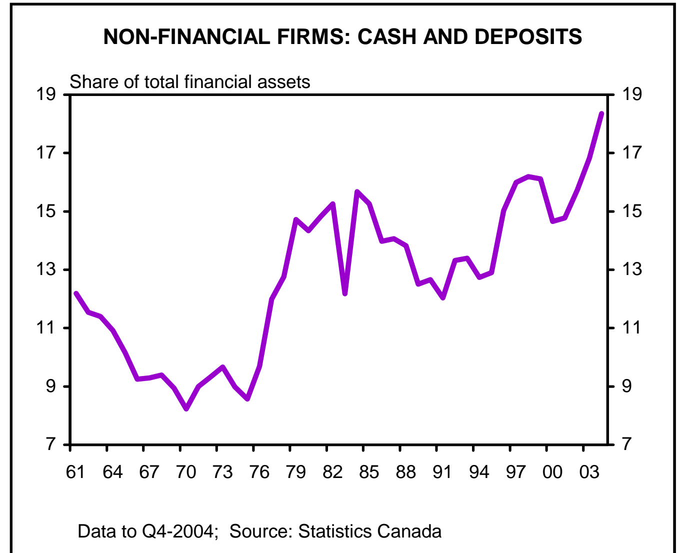
Balancing Act: Cautious savings vs. increased risk appetite

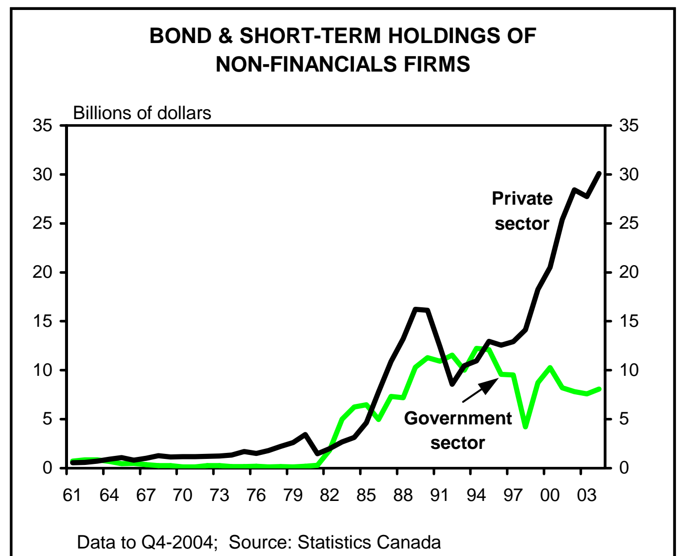
Diminished liability exposure and high cash positions have enabled firms to absorb more investment risk. As we mentioned earlier, one way in which this behaviour has manifested itself is through increased M&A ventures. But, this is not the only way. Since 2001, non-financial firms have shown a distinct preference to hold private sector debt instruments over government instruments. Granted, bonds and short-term instruments make up just 3 per cent of financial assets – placing them low on the asset priority list. However, it stands as another example of a greater willingness to take on more investment risk.

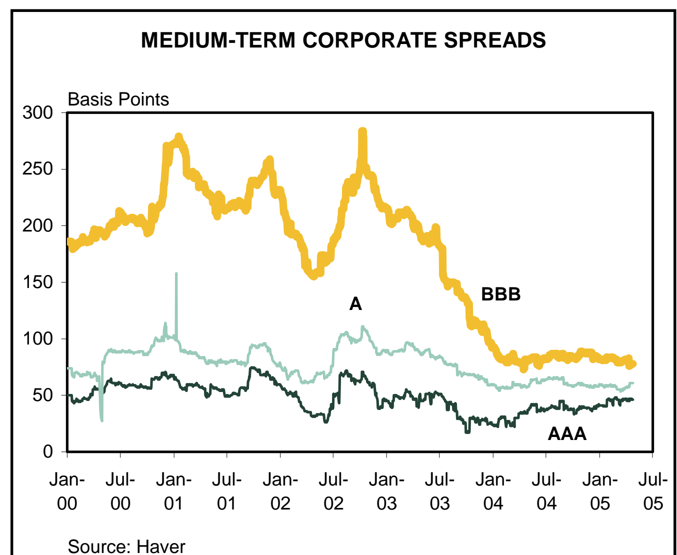
At first glance, it appears that the riskiness of this investment choice is diminished by the fact that the nationwide trend to shore up corporate balance sheets has reduced the odds of default risk on corporate bonds. And, to some degree, this is true. But, it is more likely the case that a sustained low inflation, low interest rate global environment has propelled firms to seek higher yielding asset products in the corporate bond market. In turn, this may have caused firms to absorb a greater degree of risk than would otherwise be the case. The graph below indicates that corporate-government yield spreads for lower quality BBB corporate bonds have collapsed by 150-basis points from 2002 to 2004, and have since held within a very tight and low 79-84 basis points range. Meanwhile, there has been far less movement in the spreads for higher credit quality bonds (AAA and A). In fact, spreads for the most highly regarded AAA corporate bonds have drifted slightly higher over the past year. As a result, it appears that the narrowing of corporate spreads has less to do with the healthy state of corporate balance sheets and more to do with a low global interest rate environment that has increased the desire among market participants to seek out higher yielding products.

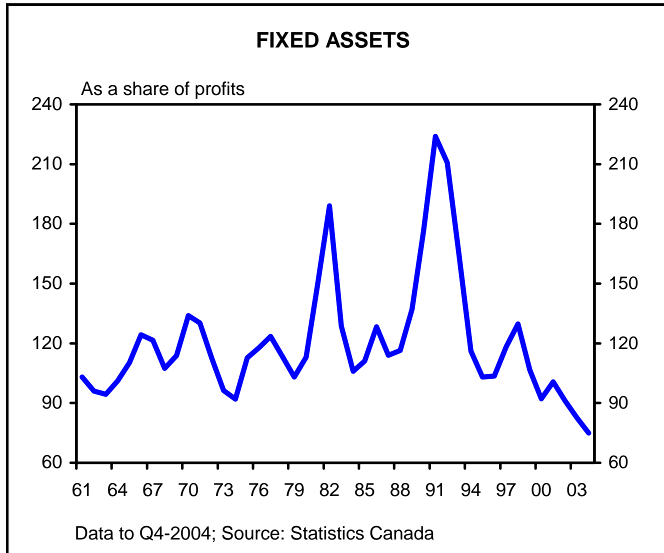
How did they do it?

With few exceptions, Corporate Canada is flush with cash, which is a product of strong profit growth, reduced financial liabilities, and disciplined cost controls. Even in areas where firms have made a more concerted effort to increase spending, initiatives still fall short of profit growth. For example, a divide has occurred between the rate of growth in profits and fixed capital investment. In 2004, the









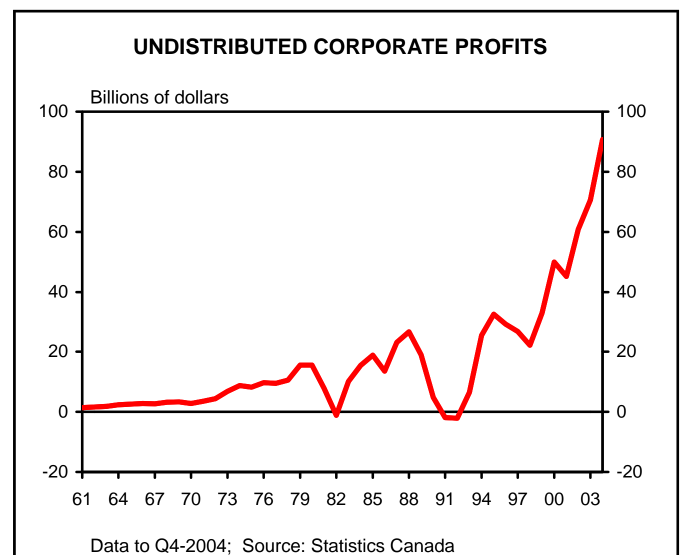
volume of investment in machinery and equipment (M&E) was up 11 per cent relative to 2001 levels, leaving the impression that firms have maintained a reasonably healthy pace in investment spending. However, prices for M&E capital have declined over this period, in part due to the fact that the vast majority of equipment comes from the United States and the rise in the value of the Canadian dollar has been a cost-advantage to importing. Tallying it up, nominal investment has risen by only 7 per cent from 2001 to 2004, which is about one-sixth the gain seen in profits over this period. As a result, fixed assets as a share of profits were at an all-time low in 2004, suggesting that firms are under-investing relative to profit growth.

But nothing happens in a vacuum. Firms worldwide have weathered a series of global shocks in recent years that have perhaps led to more cautious behaviour. To this point, it wasn't until mid-2004 that the U.S. Federal Reserve felt the risks to the economic landscape abated sufficiently to lift domestic interest rates from "emergency low levels". Meanwhile, a rate hike cycle in Canada was abruptly halted when evidence emerged that export-oriented activity was deteriorating, dampening overall economic growth. Against this backdrop, corporations might have deemed the strong pace of profit growth as temporary, especially for those firms with activity in volatile commodity-related sectors. Even so, the degree and extended period of profit gains makes it ever more likely that the resulting high level of retained earnings will increasingly feed into investment and other corporate initiatives.

Risks abound

The road ahead won't necessarily be a smooth one. Many of the global risks that caused firms to become rooted in cautious saving behaviour in past years will continue to exist. At last count, economic activity was fraying in a number of economies including Italy, Switzerland, Germany, and Japan. Meanwhile, the global foreign exchange rate risks posed by the massive current account and fiscal deficits in the U.S. will continue to overhang financial markets, especially since either one of these deficits could push to new record levels in 2005. And, more recently, a new global financial risk has taken shape. The dramatic increase in liquidity due to a prolonged period of globally low interest rates may have caused financial market participants to miss-price asset risk and become overly leveraged and inadequately diversified. For further details see the TD Economics publication entitled "*Threats to Global Financial Stability*", February 2005.

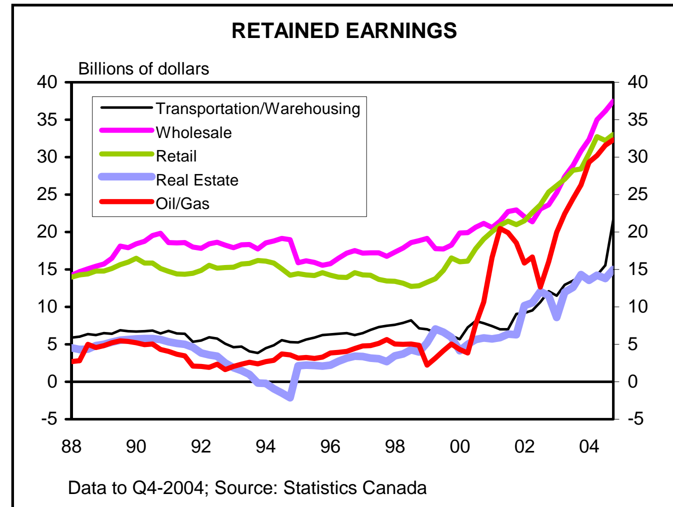
On the domestic front, the challenges are no less. Within the balance sheets of manufacturers, a division favoured commodity producers over non-commodity producers (see Box 1). A sustained period of dramatically higher commodity prices has shielded producers of these goods from the painful adjustment of a higher valued Canadian dollar. However, this raises the possibility that a meaningful pull back in commodity prices could limit the extent to which these firms redistribute retained earnings back to stakeholders. Currently, the risk of a sharp pull back in commodity prices is limited, given that we expect world

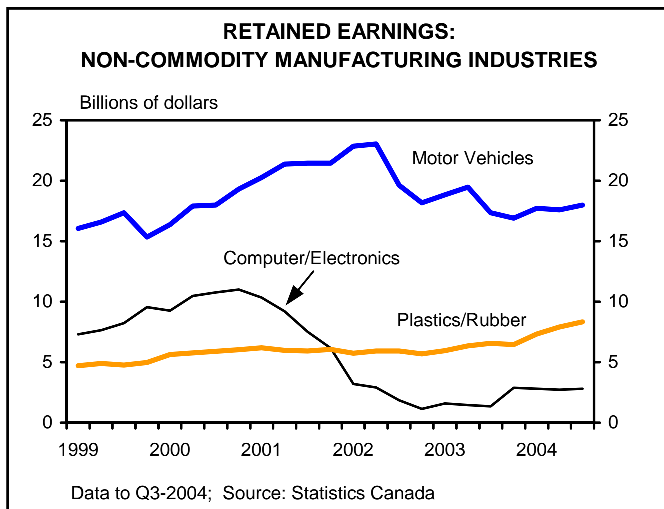


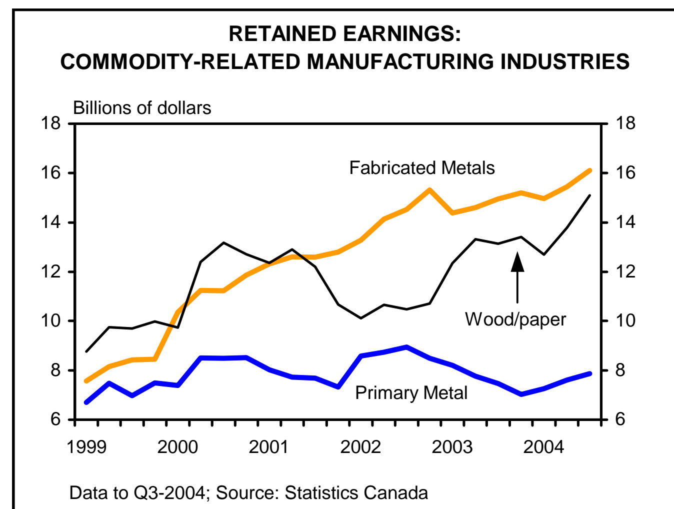
Box 1

NOT ALL INDUSTRIES CREATED EQUAL

Strengthened profits and the trend towards higher retained earnings is a consistent theme within the various sectors of the non-financial industry, whether it is retail, wholesale, oil and gas extraction or real estate. In particular, profit margins in the oil and gas sector have increased in response to a sustained period of dramatically higher oil and natural gas prices. At the same time, a hot housing market has propelled profits and retained earnings in the real estate sector, while retail and wholesale sectors have benefited from sound domestic demand. The level of retained earnings in many major sectors is at a 17 year high – the data on a sector basis extends only to 1988. This is even the case for the export-oriented manufacturing sector, which has been battling the headwind of a sharp loss in competitiveness under a near-30 per cent rise in the loonie since the beginning of 2003. This is a particularly interesting phenomenon because unlike most other sectors, manufacturing profit margins were squeezed, averaging 6 per cent over the 2001 to 2004 period compared to more than 7 per cent from 1995 to 2000. And yet, retained earnings climbed. Upon further investigation, it is evident that high retained earnings was more likely to be found among commodity-based producers – i.e. oil and gas extraction, mining and even forestry products – which have benefited from a powerful commodity price rally. In contrast, computer/electronics and motor vehicle sectors have realized a substantial reduction in retained earnings alongside softening profits.







economic growth to clock in just above 4 per cent in 2005. However, corporations will probably still be wary of an inevitable slowdown in commodity price growth from the frenzied pace of the last two years. Meanwhile, less robust balance sheets among non-commodity manufacturers substantiate the weak data that is being transmitted on the export side of the economy. The auto and electronic sectors detailed in Box 1 are but two examples where firms are still trying to adjust to the loss in competitiveness. Likewise, there is a very real risk that restructuring and cost cutting measures in these sectors could extend to related labour and investment, keeping in mind this would likely be

a sector-related impact and not a nationwide one.

Conclusion

On average, profit growth was running at more than twice the pace of nominal GDP growth over the past three years, but at this stage in the cycle, it is reasonable to expect re-alignment between the two towards a 5-per-cent pace. This would keep profits at a record share of GDP (14 per cent), but also open up the possibility that high retained earnings will further fuel merger and acquisition activity, with perhaps some greater allocation towards investment and shareholder distributions. In fact, it appears that the first leg of this adjustment is already underway. Profit growth in the second half of 2004 slowed to a 6-per-cent annualized quarterly pace, a fraction of that recorded over the previous two and a half years.

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