SPECIAL REPORT

TD Economics

October 30, 2012

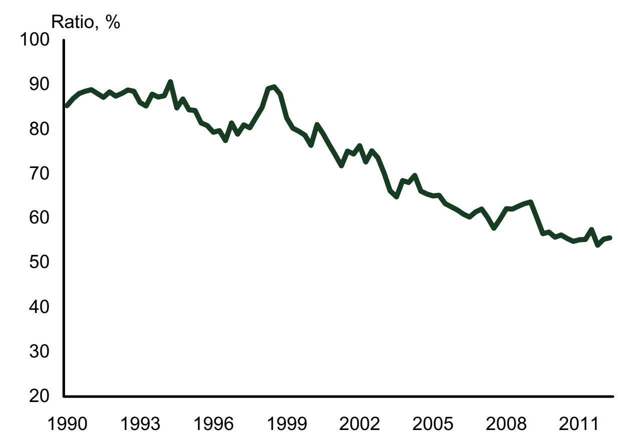
CANADIAN CORPORATE BALANCE SHEETS SOLID AS A ROCK

Highlights

- If we compare the current standing of corporate balance sheets in the first half of 2012 to what they looked like some 20 years ago, the picture has brightened significantly.
- Financial ratios have improved markedly over the last two decades, including a decline in debt-to-equity and improved liquidity.
- Improvements have been driven by solid growth in assets, led by strong profitability. In addition, over the past twenty years, non-financial corporations have elected to finance investments more through internally generated cash and issuing stocks than has historically been the case.
- Over the last 20 years there has been a growing preference of businesses to build financial assets. In particular, cash was the fasted growing asset during that time. This trend has accelerated since the 2007-2008 financial crisis, as Canadian companies focus on risk management.
- Going forward, a softer profit environment will likely keep asset growth more modest. We are likely to continue to see a heightened preference for cash over the next 6-9 months. However, over the medium-to-longer term we anticipate that non-financial corporations will start to invest less in cash and more in fixed capital. Debt will grow as a more important source of funding those investments.

In contrast to other sectors of the economy, Canadian non-financial corporations have seen a marked improvement in the health of their balance sheets over the last two decades. A two decade perspective allows a comparison of balance sheets coming out of the 1990's recession to that of the recent downturn and recovery period. During the early 1990s, businesses appeared to be in rough shape. Canadian non-financial corporations barely had enough assets to cover their debts. Since then, a two fold increase in profitability has helped Canadian businesses grow their assets at a solid pace, keeping leverage low and increasing liquidity. Since the 2007-2008 financial crisis, these long-term trends have remained largely intact, but the desire to hold cash has risen to a new level. These factors would stand the corporate sector in good stead in the event that global financial conditions deteriorate rapidly. Over the medium term, the healthy standing of corporate balance sheets will likely lead to a stronger pace of business investment and overall real GDP growth for the Canadian economy.

CHART 1: PRIVATE NON-FINANCIAL CORPORATION'S DEBT*-TO-EQUITY RATIO



*Includes bank loans and issued debt
Source: Statistics Canada

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Hard work pays off

Ratios used to measure a firm's leverage include the debt-to-asset and the debt-to-equity ratio. In the case of liquidity, or the ability to pay off upcoming debts, barometers typically comprise of the current ratio (short term financial assets-to-liabilities) and the quick ratio (cash-to-total liabilities). Short term refers to an asset or liability with a life span of less than five years.

Looking back to the 1990s, Canadian non-financial corporations were worse off financially than they are today (Chart 1 to 2). In fact, the current ratio suggests that Canadian corporations looked to be in rough shape in the early 1990s. Following the early 1990s recession, non-financial corporations recorded a current ratio of 0.8 – meaning they barely had enough financial assets to cover their upcoming debts. Today, the comparable figure is almost $2 worth of short-term assets

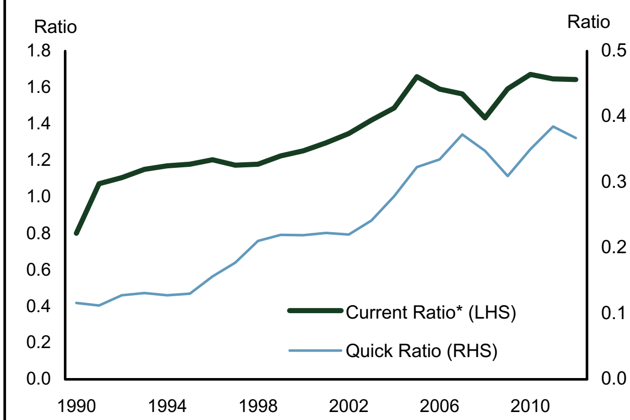
Profits drive solid asset growth

While businesses have been reducing risk on their balance sheets in a structural fashion since the early 1990s, these efforts have not come at the expense of a solid expansion in assets (Chart 3). The most notable period of asset growth took place during the run-up to the 2008-09 recession. After recording a sharp pull-back in the downturn, asset growth has since resumed at a decent clip.

There has also been a shift in the way businesses fund the assets on their balance sheets (Chart 4). Assets can be funded in three ways – through retained earnings, issuing equity or borrowing. Over the past twenty years, non-financial corporations have elected to finance investments more through internally generated cash and issuing stocks than has historically been the case, leading to a decline in the debt-to-equity ratio. Retained earnings have been the largest source of balance sheet expansion, reflecting rapid profit growth, particularly during 2002-2008. Over that pre-recession period, global and domestic demand was booming allowing firms to enjoy some additional pricing power. Total pre-tax profits doubled across most industries during that time. In addition, lower corporate taxes and higher dividend tax credits since 2005 have likely increased the allure of equity by reducing the tax burden borne by shareholders.

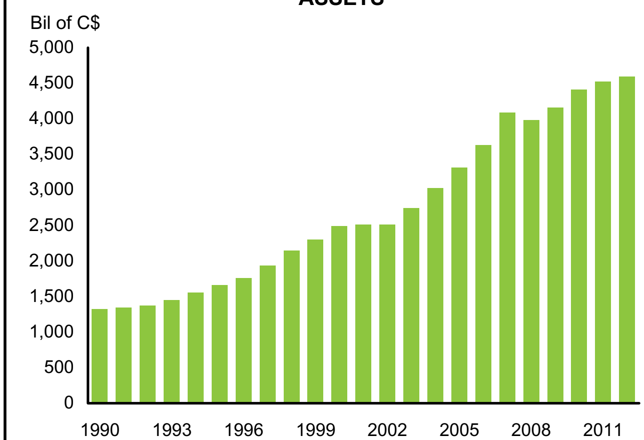
The pendulum has swung modestly back to debt financing since the recession. This development reflects in part, foreigners increased preference for Canadian fixed income

CHART 2: NON-FINANCIAL CORPORATION'S LIQUIDITY RATIOS



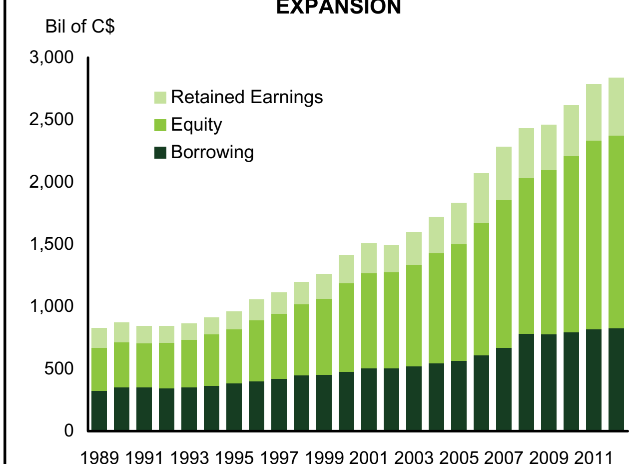
*Short-term refers to assets and liabilities with a life span of less than five years
Source: Statistics Canada

CHART 3: TOTAL NON-FINANCIAL CORPORATE ASSETS



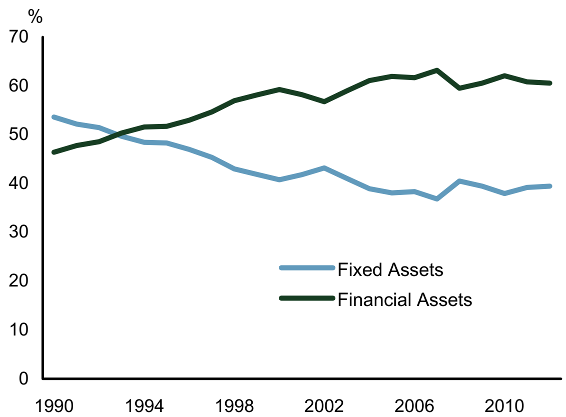
Source: Statistics Canada

CHART 4: SOURCES OF BALANCE SHEET EXPANSION



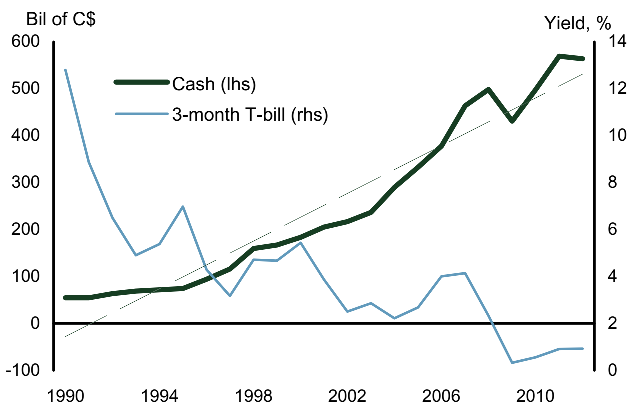
Source: Statistics Canada

CHART 5: SHARE OF TOTAL ASSETS



Source: Statistics Canada

CHART 6: CASH BALANCES ON NON-FINANCIAL CORPORATION BALANCE SHEETS



Source: Statistics Canada

assets such as corporate bonds, and the resulting lower cost of borrowing. Leverage remains well below its levels of a decade ago. However, for the first time since 2003, borrowing through bank loans and corporate bond markets grew at a faster pace than assets since the recession struck. In particular, corporate bond issuance accelerated on an annual basis since 2007.

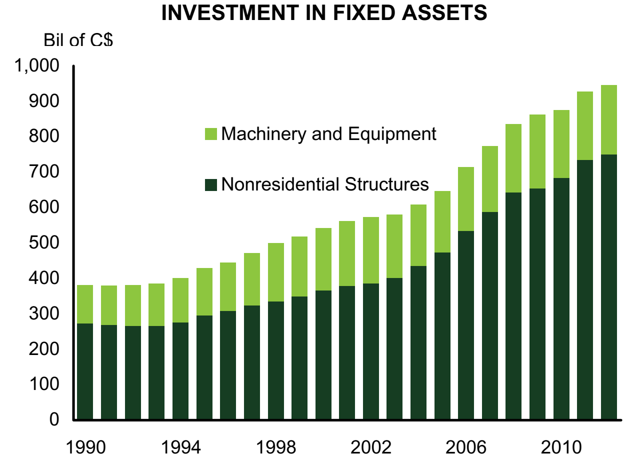
Businesses prefer cash

Non-financial corporations can hold many types of assets. Fixed assets include machinery and equipment, real estate and inventories. Financial investments include bank deposits, stocks and bonds. Over the last 20 years there has been a growing preference of businesses to build financial assets, as evidenced by improving liquidity ratios (Chart 5). In particular, cash was the fasted growing asset during that time as a trend decline in interest rates lowered the opportunity cost of holding cash relative to other fixed income assets or alternative financial products.

Since the financial crisis in 2007-08, the trend towards holding cash on balance sheets has further intensified as a form of risk management. This past downturn was not your plain vanilla recession – it was a financial crisis. Credit markets froze, making it harder for businesses to borrow in 2008 – especially since a large share of Canadian corporate borrowing occurs in U.S. markets. Even as the recession faded, financial risks have remained elevated. Will the European financial crisis lead to a renewed global financial crisis? Will the U.S. dive off its fiscal cliff? As a result, the increase in liquidity for Canadian corporations was more pronounced and sustained than has been the case in past recessions. Cash balances increased almost 50% since 2007. As at the second quarter of 2012, cash held on balance sheets in the form of deposits had jumped to $567 billion. As chart 6 shows, if the recent historical upward trend was maintained, this cash balance would be at a lesser $525 billion, or about 10% lower. However, much of the additional cash has been generated through borrowing. As a result, liquidity ratios such as the quick ratio (cash-to-total liabilities) have remained relatively stable (chart 2).

The pace of growth in fixed assets has been slower than that in financial assets over the last twelve years. Although a pickup in investment spending during the recent recovery has helped to stabilize the non-financial-asset share of

CHART 7: NON-FINANCIAL CORPORATION'S INVESTMENT IN FIXED ASSETS



Source: Statistics Canada

Chart 8: Financial Ratios by Industry
Average level in given year

	Debt-to-equity				Quick Ratio (cash-to-total liabilities)			
	1990	2000	2007	H1 2012	1990	2000	2007	H1 2012
Resources	1.01	1.13	0.80	0.78	0.07	0.03	0.08	0.10
Manufacturing	0.77	0.58	0.75	0.67	0.04	0.07	0.09	0.10
Retail Trade	1.43	1.22	1.21	0.80	0.07	0.09	0.12	0.16
Other Industries	1.73	1.66	1.37	1.28	0.06	0.07	0.12	0.15

Source: Statistics Canada

total assets, fixed assets only account for 40% of corporate savings – compared to over 50% in the early 1990s. Digging deeper, investment in nonresidential structures (real estate) has been the sharpest growing source of business investment over the last 12 years, while investment in machinery and equipment has grown by an average 1.0% per annum since 2000 – significantly lower than the 7-8% gain in real estate assets. As such, the share of machinery and equipment has lost even more ground within the total asset pie than non-residential structures (chart 7), which is concerning given that equipment spending is a significant driver of productivity.

Resources lead improvement

In large part, some of the improvement in overall balance sheets reflects the growing importance of the resource sector. These companies tend to be less leveraged and historically have financed assets more heavily through stock markets – hence the large presence of resource stocks on the S&P/TSX stock exchange. But, digging down into the details, the improvement in balance sheets has been wide-spread across industries. The greatest improvements have been in industries where profits grew the strongest, including construction, resources and retail trade (Chart 8).

Manufacturing has been an exception to the rule. The industry was enjoying an improvement in financial health until the early 2000s. However, a high Canadian dollar and decreased competitiveness has since curbed profitability for the industry. The debt-to-equity ratio for manufactures gradually rose back to mid-1990s levels as stock prices have been hurt. Having said that, manufacturers have been making a conscious effort to shore up balance sheets. Manufacturers have slowed their pace of borrowing considerably since 2000 and have been storing cash to help improve liquidity.

Canada vs U.S.

A question is raised as to whether these trends are being mirrored in the United States. Chart 9 compares a number of key metrics across non-financial sectors in the two economies. Some of the key highlights include:

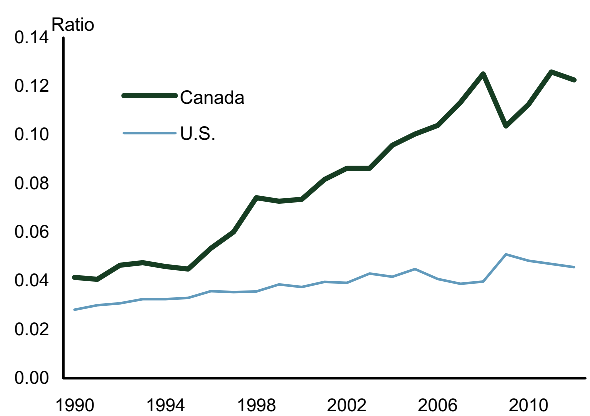
- Similar long term trends in the balance sheets occurred south of the border.
- Canadian businesses tend to be more leveraged than their U.S. counterparts. Businesses tend to be larger in the United States. The bigger the company, the less levered they usually are given greater access to equity markets. More generally, U.S. companies enjoy deeper capital markets offering greater choice for financing other than debt.
- U.S. businesses are more liquid, as evidenced by a higher current ratio.

Chart 9: Non-Financial Business Balance Sheets

	Canada			U.S.		
	1990	2000	2012 to date	1990	2000	2012 to date
Debt-to-Assets	**0.36**	**0.34**	**0.33**	**0.26**	**0.24**	**0.27**
Current Ratio	0.80	1.25	1.64	1.04	1.41	1.98
Debt-to-Equity Ratio	0.89	0.69	0.59	0.87	0.38	0.51

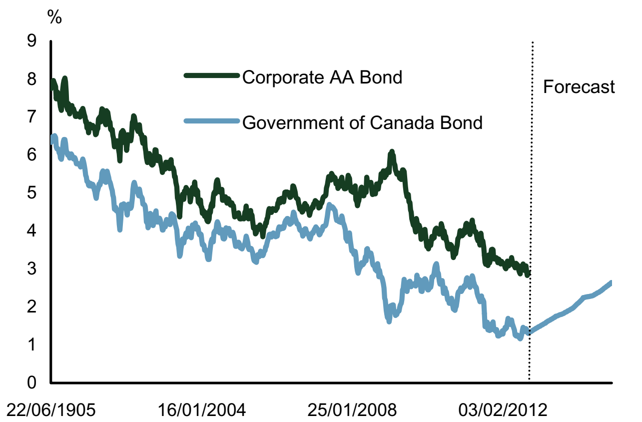
Source: Statistics Canada, Federal Reserve

CHART 10: RATIO OF CASH-TO-TOTAL ASSETS FOR NON-FINANCIAL CORPORATIONS



Source: Statistics Canada/Federal Reserve

CHART 11: CANADIAN 5-YEAR BOND YIELDS



Source: Bloomberg
F. By TD Bank Group as of October 2012

- Compared to the U.S., Canadian corporations hold more cash on their balance sheet. This has been especially true through the last 4 years. This likely speaks to the more conservative nature of Canadian corporations. One would expect Canadian companies to hold a greater cash buffer than their U.S. counterparts because their profits are more closely tied to factors such as commodity prices and the exchange rate – variables that tend to be highly volatile, particularly in times of deep uncertainty such as these.

Keep in mind that corporate balance sheets between countries may also reflect different mixes of industries that have different financial characteristics and structures. For instance, the resource and manufacturing sector are more important drivers of economic growth in Canada than is the case in America.

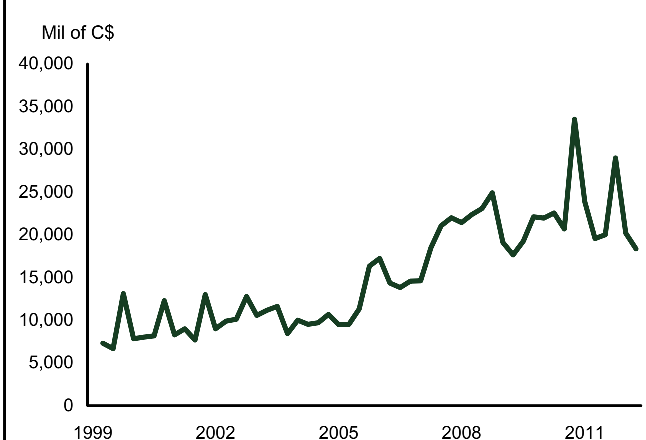
Corporations to build fixed assets

While little change from recent trends is expected over the next 6-9 months – and notably the desire for companies to hold cash in an uncertain environment – more pronounced shifts are anticipated over the medium-to-longer term. Notwithstanding varying sector performances, overall asset growth of Canadian non-financial corporations is likely to remain moderate over the next 2-3 years in a climate of moderate Canadian and global economic expansion and mid-to-high single digit profit growth. The bigger story is likely to be a shifting mix of assets and liabilities on non-financial corporate books. As the Bank of Canada gradually raises interest rates in the 2013-15 period, the opportunity cost of sitting on cash will increase because fixed income investments will offer higher returns. In addition, some of the cash sitting on balance sheets will likely be distributed as dividends to shareholders. As chart 12 shows, businesses have shown an increased preference for issuing dividends and share buy backs to offer investors a return.

More importantly, as some of the storm clouds overhanging the global economy dissipate, Canadian companies are expected to increase their focus on building up fixed capital assets. All signs point to a pick up in fixed capital spending. Business tax rates in Canada are competitive. The strong state of balance sheets themselves is typically a strong leading indicator of investment in non-financial assets. In analyzing investment trends across G7 economies, Bank of Canada research shows that lower debt-to-equity ratios and higher liquidity tend to invest more heavily in fixed assets [1]. At the same time, Canadian companies appear to have built up significant pent up demand for machinery and equipment, which along with the high Canadian dollar which lowers the price of imported capital goods, should lead to higher spending on equipment. Although the outlook for moderate growth in the economy and corporate profits will limit the prospects for an investment boom, TD Economics is forecasting solid investment spending of 8-10% per year in the 2013-14 period.

Another development that could gather strength over the medium term is that of the recent move towards debt financing. Despite the likely gradual increase in interest rates over the next few years, corporate rates are expected to remain relatively low and attractive. Canadian corporations can pick-up borrowing at low interest rates without

CHART 12: NON-FINANCIAL CORPORATIONS: CASH APPLIED TO DIVIDENDS



Source: Statistics Canada

materially altering leverage or liquidity ratios. In addition, a low debt-to-equity ratio provides Canadian corporations with scope to take on leverage.

Bottom Line

Balance sheets of non-financial corporations in Canada are strong. Companies have managed to build up assets while at the same time reducing leverage and increasing liquidity. Indeed, unlike households and governments, companies are less vulnerable today than they were heading into the 2007-08 global financial crisis. Over the longer-term we would expect some of the recent trends to reverse course, especially as the opportunity cost of holding cash begins to gradually pull off its lows. We are optimistic that an increasing share of growth in retained earnings and other funding sources is allocated towards new investment, which would provide a boost to Canada's long-term growth potential.

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Endnotes:

1. Graham, Christopher and Denise Cote. "Corporate Balance Sheets in Developed Economies: Implications for Investment". Bank of Canada, March 2007. http://www.bankofcanada.ca/wp-content/uploads/2010/03/wp07-24.pdf