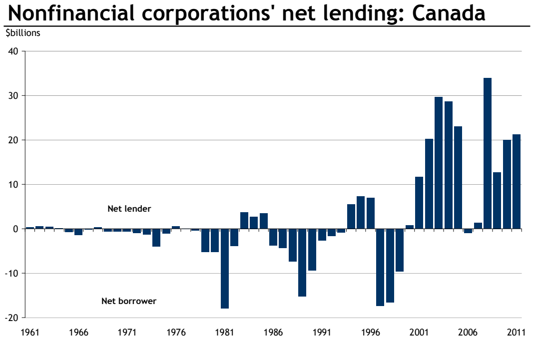
RBC ECONOMICS | **RESEARCH**

CURRENT ANALYSIS

January 2013

Chart 1

Nonfinancial corporations' net lending: Canada



Source: Statistics Canada, RBC Economics Research

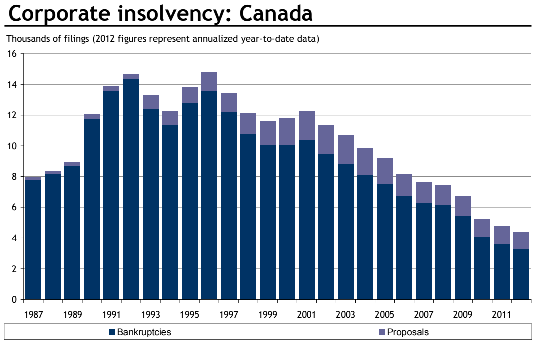
Chart 2

Nonfinancial corporate solvency: Canada

Source: Statistics Canada, RBC Economics Research

Chart 3

Corporate insolvency: Canada



Source: Office of the Superintendent of Bankruptcy Canada, RBC Economics Research

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Canadian businesses ready and able, not yet willing

Thus far through the recovery, the Canadian economy has benefited considerably from the robust activity on the consumer side as easy borrowing conditions have helped to support personal spending and, to a greater extent, elevated levels of activity in the residential real estate market. As we move into a period in which the housing market moderates as it transitions to more sustainable path and consumers confront their growing debt levels, the expectation is that Canadian businesses will pick up some of the slack via more robust spending on capital equipment than was seen over the last year. This note will look into the state of Canadian corporate finances to determine if firms can support an even faster economic expansion in 2013 and 2014.

Corporate balance sheets have evolved over time…

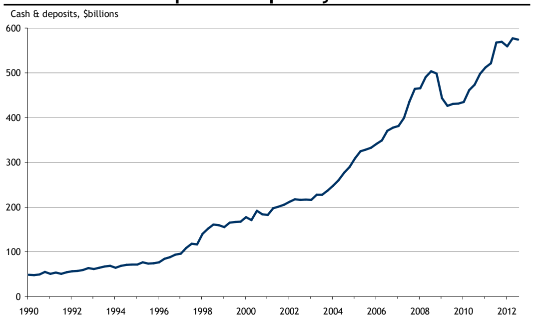
The last three decades have seen a remarkable change in the state of Canadian corporate finances. Prior to the mid-1990s, Canadian nonfinancial corporations were typically net borrowers (chart 1), meaning that business investment in fixed capital and inventories generally exceeded internally generated funds (corporate profits and savings). As a result of these financial deficits, firms became highly leveraged as evidenced by aggregate debt-to-equity ratios hitting peaks in the early 1990s (chart 2) and the solvency position of Canadian businesses deteriorated accordingly. Compounding this was the relatively high interest rate environment that prevailed in the 1980s that increased the costs associated with carrying debt and placed added strains on corporate finances. The weakened financial position made firms vulnerable to economic shocks as was evident in business insolvency data that showed sharp increases in filings following the early 1990s recession (chart 3).

…and business finances are now in excellent shape

Since the mid-1990s there has been a sustained improvement in business balance sheets. Corporations turned from net borrowers to net lenders (meaning that internally generated funds were more than enough to meet investment needs) and used the surplus positions to reduce leverage and shore up capital reserves. Firms were able to make this financial turnaround for a few reasons: increased profitability (demand for Canadian goods and services increased significantly led by the natural resource boom that contributed to the large current account surplus until the recession); lower aggregated corporate taxes (effective corporate tax rates have fallen fairly steadily since the mid-1990s); lower debt costs (due to the combination of lower debt loads and a declining interest rate environment); and declining costs of technology helped in part by a strong Canadian dollar. The structural shift in the corporate financial position was a key reason why Canadian firms were able to successfully weather the economic turbulence of the past decade from the bursting of the technology bubble in the early 2000s to the recent global financial crisis. Canadian insolvency filings have exhibited an unambiguous downward trend over this period (chart 3).

Chart 4

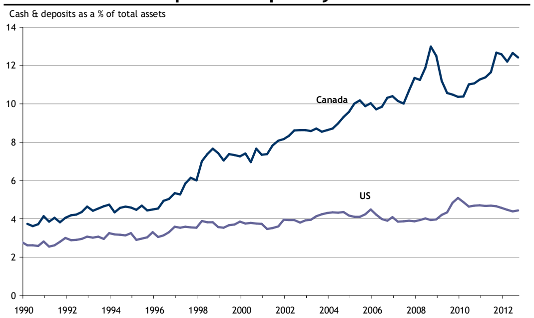
Nonfinancial corporate liquidity: Canada



Source: Statistics Canada, RBC Economics Research

Chart 5

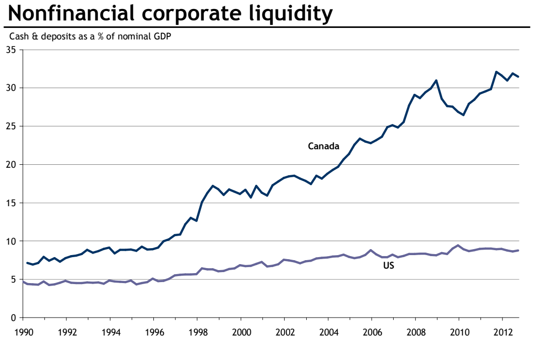
Nonfinancial corporate liquidity



Source: Statistics Canada, Federal Reserve Board, RBC Economics Research

Chart 6

Nonfinancial corporate liquidity



Source: Statistics Canada, Federal Reserve Board, Bureau of Economic Analysis, RBC Economics Research

Cash is king

The conservative approach to managing balance sheets by Canadian firms continued after the downturn even as corporate profits rebounded from recessionary lows and business established record high levels of liquid assets (such as cash and other financial assets that can converted into cash quickly and with minimal impact on the price received). Specifically, Canadian nonfinancial businesses held $574 billion in aggregated currency and deposits at the end of the third calendar quarter of 2012[1] (chart 4). This represents a historically elevated absolute amount of cash on hand and accounted for 12% of total assets of these businesses (chart 5). To put these figures in an international context, currency and deposits represent less than 5% of total assets on balance sheets for nonfinancial firms in the US (chart 5). Further, Canadian businesses hold cash equal to approximately one-third of nominal GDP (32%), roughly four-times the levels in the US (chart 6).

Money for nothing...

The elevated corporate liquidity has drawn attention from policymakers with the Governor of the Bank of Canada chiding businesses for sitting on too much "dead money." Firms traditionally hold cash in order to meet their financial obligations such as paying employee salaries, purchasing inventories and servicing debts. When a firm has a need for cash, but that need is not immediate (i.e. it has to meet an obligation due in three months), the money can be invested into liquid financial assets to earn a return in the meantime; simply holding the cash does not yield a financial return for the company. Stakeholders in a business (such as investors and lenders) prefer that the firm maintain an adequate level of liquidity so that it can easily manage any unforeseen obligations that may arise without compromising the normal operation of business. Excessive liquidity, however, is viewed negatively because stakeholders may determine that the unnecessary cash holdings could be put to better use in generating returns via investment or a distribution of the funds to shareholders. Retaining too much cash is thus an inefficient use of resources and restrains economic activity and growth.

... or is there a method to the madness?

There are arguments that can be made in support of firms holding historically elevated levels of liquidity in the current global macroeconomic environment. Recent experience has shown that financial stress can result in the flow of capital in financial markets grinding to a halt and restricting needed access to funding by businesses. Given the persistently high degree of uncertainty about the global economic outlook, it is thus reasonable that firms would opt to hold a relatively larger cash buffer lest they be caught short when the next crisis rears its ugly face.

Another reason for firms' preference for cash relates to corporate pension plans. The combination of a low interest rate environment and uncertain returns in equity markets can have a significant impact on the funding position of pension funds. In the case of defined benefit pension plans, the corporation is ultimately responsible to pay for any pension shortfalls and thus must have cash readily available to fill gaps as needed. With interest rates likely to remain historically low and the economic outlook cloudy, corporations face significant uncertainty regarding funding deficits, creating some impetus to maintain higher levels of precautionary liquidity.

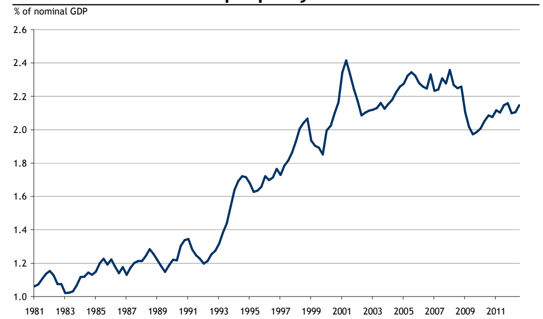
Statistics Canada[2] noted that investments in intangible capital (a nonfinancial asset that lacks physical substance such as software, patents or research and development) are playing an increasingly important role in the business sector. Business investment in intellectual property has trended higher as a share of nominal GDP since the early 1980s with a particularly noticeable pickup seen starting in the middle of the 1990s (chart 7). This type of investment has been found[3] to increase the demand for cash since, in contrast to investment in tangible capital such as machinery and equipment, investment in intangible capital does not involve a physical asset that may be pledged as collateral. Firms engaging in large-scale intangible investment (i.e. undergoing substantial research and development) can thus face a lesser degree of financial flexibility than would otherwise be afforded to them if they were investing in physical capital. As well, having cash on hand as opposed to having to raise funds from external sources can allow firms the flexibility to move quickly on new ideas and innovations. For these reasons it makes sense for firms to stockpile greater cash reserves in order to meet their financing needs for projects.

Lying in wait

Returning to the question posed at the outset: can Canadian businesses fill the void in the Canadian economy left by reduced growth in the household sector? Nonfinancial corporations took advantage of record profits, historically low interest rates and relatively strong stock markets prior to the recession to substantially improve their balance sheets. The structural shift in the corporate financial position was likely a key reason as to why Canadian firms were able to weather the economic storm of recent years relatively unscathed. The continued conservative approach to balance sheet expansion has firms in excellent financial shape and allowed them to take advantage of highly accommodative financial conditions to increase their use of external financing in the second half of 2012 (chart 8). As a result, Canadian businesses possess the capacity to provide support to the overall economy by ramping up investment. Moreover, the most recent *Business Outlook Survey* from the Bank of Canada showed that the majority of companies intend to increase investment in machinery and equipment and expand payrolls over the coming year, with the margin increasing modestly following the decline in the previous quarter (chart 9).

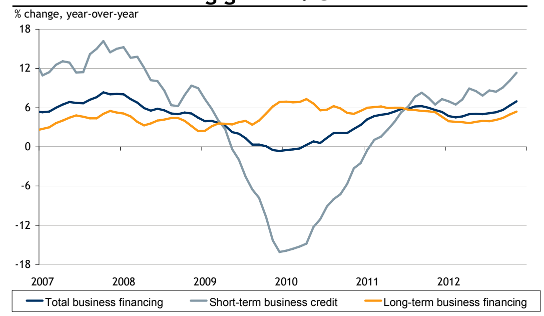
With the global economic environment still highly uncertain and likely to remain so over the near-term, however, it is likely that Canadian firms will continue to err on the side of caution, suggesting that the financial surplus positions will not likely be unwound in the coming months. As more clarity becomes evident in the economic outlook and external risks subside, Canadian businesses stand ready to take advantage of opportunities as they present themselves and we anticipate that a stronger pace of business investment in structures, machinery and equipment should materialize in the second half of 2013 as firms deploy their ample liquid balances (chart 10).

Chart 7
Business intellectual property investment: Canada



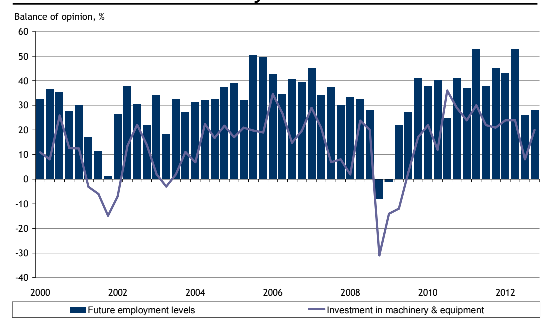
Source: Statistics Canada, RBC Economics Research

Chart 8
Business financing growth: Canada



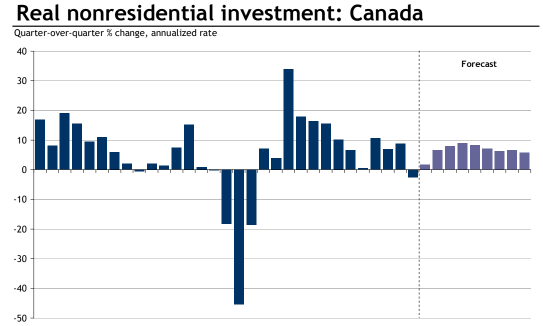
Source: Bank of Canada, RBC Economics Research

Chart 9
Business Outlook Survey: Canada



Source: Bank of Canada, RBC Economics Research

Chart 10
Real nonresidential investment: Canada



Source: Statistics Canada, RBC Economics Research

Notes:

1. The data used in this analysis is that for nonfinancial private corporations from Statistics Canada's *National Balance Sheet Accounts*, CANSIM table 378-0121.

2. *Intangible Capital and Productivity Growth in Canada*. Statistics Canada Catalogue No. 15-206-X. The Canadian Productivity Review. No. 29. June 2012.

3. For a greater discussion on this topic of intangible investment and liquidity, see Christopher F Baum & Mustafa Caglayan & Oleksandr Talavera. "*The Effects of Future Capital Investment and R&D Expenditures on Firms' Liquidity*," Boston College Working Papers in Economics 712, Boston College Department of Economics, November 2012.