



Financial Industry Monitoring Service

In-depth analysis of developments in the Canadian and U.S. financial services industries

Unique opportunities to unlock value from Canadian companies

March 2006

Executive summary

The impressive state of corporate finances combined with challenges to Canada's competitiveness make for a rare window of opportunity to pursue more investment and R&D activity, but also for mergers and acquisitions to be combined with public policy changes geared towards reducing growth barriers, and unlocking value in companies through a multi-stakeholder approach.

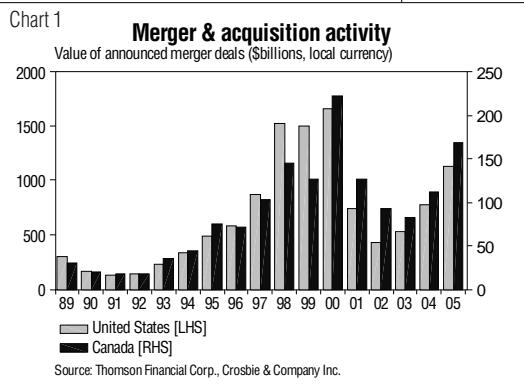
The issues at hand include long-standing challenges facing Canada's competitiveness and the absence of convincing evidence that they are being successfully addressed. The list of challenges that are external to how firms are managed includes Canadian dollar appreciation, high energy prices, technological change and globalization. The evidence on how poorly these challenges are being addressed starts — but does not end — with a weak long-term standing on productivity growth, continued under-investment in equipment and a poor track record on R&D spending.

The poor response to such challenges is reflected in the state of the nation's corporate finances. Yes, corporate profits are strong, but the gains are not being disseminated through rising living standards in the way that only sustainable productivity growth can achieve. Yes, investment spending is on the rise again partly due to the influences of currency appreciation on imported equipment, but Canada has under-invested for so long that it has a big hole out of which to climb. Further, many of our firms are high-cost small producers that are not well positioned for the global

economy, and, across many industries, capital structures are being very conservatively managed. Too many industries are playing it too safely with their debt-equity ratios, and companies are stockpiling idle cash at a record pace instead of using it to enhance their competitiveness. Ironically, because investment plans are so far behind the profit cycle, what they now hold in cash is way beyond anything needed to fund even the strongest of plans for investment or R&D spending, or to provide for a rainy day, and it would not make sense to use cash for long-term unfunded pension liabilities.

It is within this context that mergers and acquisitions should be used to unlock idled value in Canadian companies. Shareholders do not pay managers to hoard cash, have underleveraged balance sheets, and fret about risks to the point of stagnating. They pay management to have informed, aggressive approaches to meeting challenges and fleshing out opportunities. In the absence of such plans, or far higher shareholder disbursements, M&As are the disciplinary way of redeploying excess cash and addressing management issues. Indeed, the deal trend in both countries is on an upswing (chart 1), and could well break records set in the late 1990s and in a more broadly based way while lifting equity multiples.

Policymakers also have a role to play and cannot simply absolve themselves of any responsibility. Central banks have injected massive liquidity into world markets in recent years, and policymakers must ensure that it gets redeployed along non-inflationary paths by reducing growth barriers such as very high taxes, profit insensitive taxes, regulatory uncertainty, skilled labour shortages due to weak education and immigration policies, aging infrastructure and poor energy policies. These issues are also relevant to financial firms since their excess capital is primarily a symptom of weak business lending opportunities in recent years and massive client liquidity held on deposit.

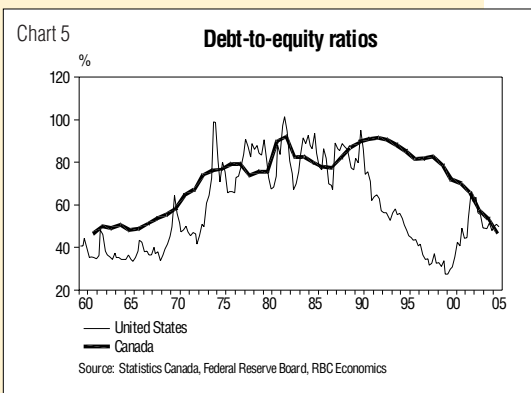
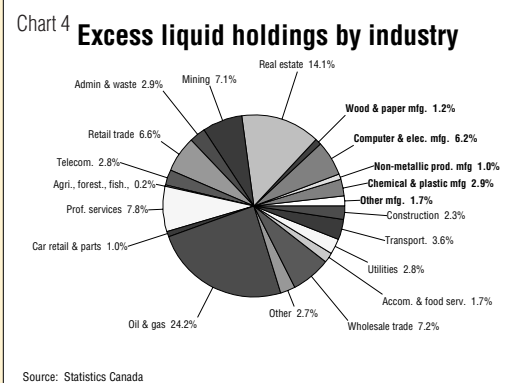
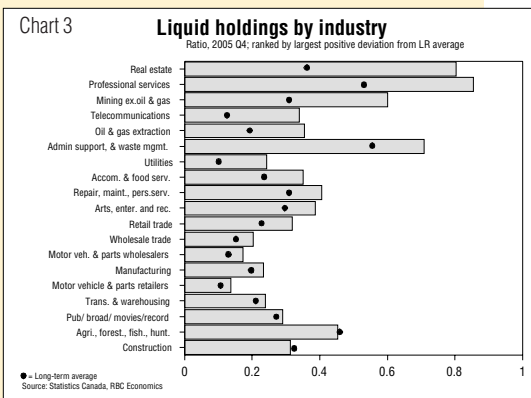


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I. Hoarding idle cash

One of the prime reasons to expect increased M&A activity is the existence of high levels of corporate liquidity in the absence of rational liquidity requirements that we will turn to later in this report. Financial theory dictates that earnings should be used to finance investments that yield returns equal to or above those required by the risk profile of the company. Alternatively, if there are no such investments, then businesses should pay these earnings out to shareholders. If a company is sitting on excessive cash balances, there are a number of reasons why M&A activity becomes more attractive. For starters, a company can use their own high cash balances to finance the purchase of another company. Alternatively, if the acquirer does not have high cash balances on its own, it can finance the takeover of a company that does and use the cash from the takeover target to shore up its balance sheet. In either scenario, high idle balances are attractive.



Based on this criterion, there has not been a more attractive time for M&As in many years. Canadian corporate liquidity soared post 2001 to its highest level ever last year (chart 2). An industry breakdown underscores this point, with almost every major industry experiencing current liquidity above long-run averages (charts 3, 4). This is particularly so for real estate, services and mining, where the magnitude of excess liquidity is large. This is also true within the manufacturing sector, where computer and parts manufacturers and mineral producers are seeing the highest levels of liquidity. In the United States, corporate liquidity stands at the highest level since the so-called Golden Era of the 1950s and early 1960s.

Next, we have to assign dollar values to the amount of excess liquidity. Looking at liquidity ratios in Canada and the United States, it appears that the run-up in balances began in earnest around 2001. If businesses brought liquidity ratios down to 2000 levels, which were already high, then Canadian companies would release over C\$80 billion in cash, and U.S. companies would release US\$450 billion.

II. Underleveraged balance sheets

There is an optimal level of debt for a company, which strikes a balance between the tax savings associated with writing off interest on debt against taxable income and the probability of incurring constraints and financial difficulties including possible bankruptcy. Some would also argue that it is good for management to face the discipline associated with meeting fixed debt payments. Therefore, if a company were financed by less than the optimal amount of debt, shifting the capital structure in favour of debt would increase the value of the company. If a company is reluctant to do this on its own, it becomes a prime candidate for another company to do it for them, via a leveraged buyout. Recent trends in the debt-equity ratio (chart 5) suggest that many companies are not exploiting the full tax advantages of debt.

To get a sense of which industries are the significant culprits, consider chart 6. In 13 of the 19 major Canadian industry groupings, current debt-equity ratios are below long-run averages and, for industries such as real estate, the deviation is large and still falling. Within the manufacturing sector, roughly one-half of the sub-industries are in a similar position. Clearly for industries facing particular challenges, this may be prudent financial management. However, as an across-the-board phenomenon, there is a possibility that corporations are underleveraged. This is true

even after accounting for the distorting inflation influences that made it advantageous for corporations to use debt in an environment of high and volatile inflation during the 1970s and 1980s and mismatched expectations across lenders and borrowers.

III. Organic profit growth tougher to come by

Merger activity may also be spurred by a company's or industry's profitability, although there are different motivations depending on where a company or industry is in its earning cycle. The first motivation is relatively straightforward. A company earning high profits can either become a cash-rich takeover candidate or an acquirer and reap any efficiency gains from consolidation. In both cases, the action is driven by the desire to obtain a larger chunk of a profitable market.

The second motivation occurs when profit margins begin to weaken, potentially signalling that companies are entering into a more mature phase of their life cycle. As such, organic growth becomes tougher to come by. This means they need to innovate or become more efficient in order to survive in a more competitive playing field, and consolidation is one route that can be taken. If we compare profit margins from year to year, an industry that is seeing its profitability start to trend down may consider consolidation as a pre-emptive action taken to stymie losses in the future by realizing gains from consolidation as soon as possible.

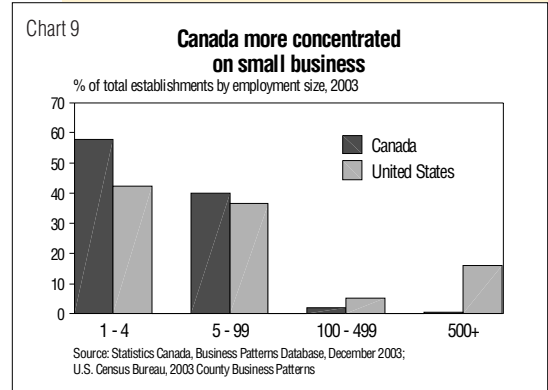
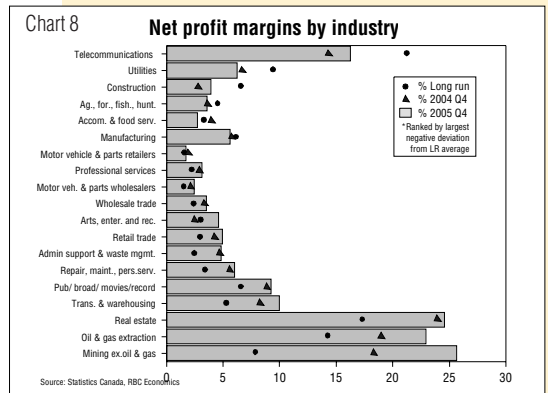
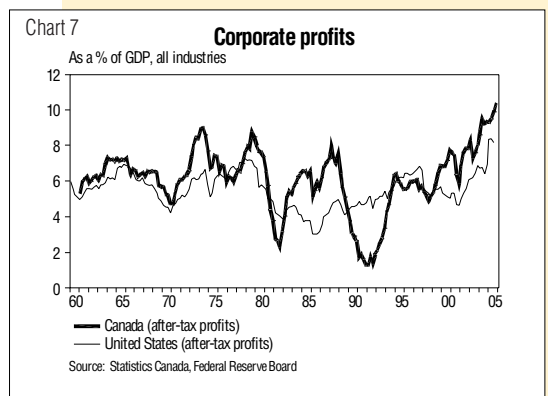
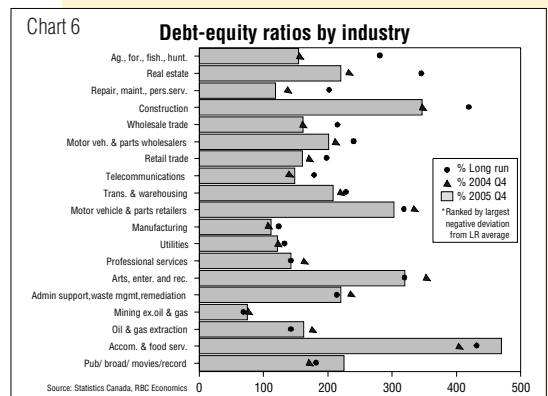
Similarly, if profit margins deteriorate to a point persistently below long-run averages, then one of the few options left for a company is to merge in an attempt to restructure its operations so that it can become a viable competitor. This may come to be the case for a few, particularly labour intensive, manufacturing sectors.

Industry-wide profit margins are above not only last year's levels, but also well above long-run averages, underscoring the point that there are many cash-rich companies that would make attractive partners (chart 7). However, there are industries that fall under the other two categories (chart 8). Using manufacturing as an example, margins have dipped slightly below long-run averages, and recent ratios appear to be showing a declining trend, with current readings falling behind last year's levels. As a result, there may be many manufacturing firms considering defensive mergers which, given the challenges to Canadian productivity, may be wise. The other scenario appears to be playing out in the telecommunications sector, where the past few years have seen profit margins fall well below long-run averages, indicating that consolidation may be necessary for survival.

IV. Canada's concentration of small businesses

An additional motivation behind M&A activity is the fact that Canada's business community is much more heavily skewed towards smaller firms than in the United States and operates with higher cost structures at lower levels of productivity than larger businesses (chart 9). This has been well documented as a significant source of Canada's productivity challenge. Addressing this through more business combinations is of heightened significance in a globalized economy.

Canada's greater focus on small- and medium-sized enterprises also influences the direction of M&A deals, often times tipping in favour of foreign acquisitions of Canadian companies. Because so many of our companies are small, it is more difficult



to acquire non-Canadian companies. This is highlighted by the average size of Canadian firms bought by foreigners, which has strongly outpaced the average size of foreign firms purchased by Canadians for most of the decade (chart 10). Because of this challenge, we may well see more Canadian companies strive for in-market synergies.

V. Too much liquidity even for stretch goals

The investment cycle fell so far behind the profit cycle over the years that cash holdings are well beyond what is needed even for stretch goals on alternative uses. While allocating more cash towards a productivity agenda is vital, much higher shareholder disbursements and M&As are still needed to redeploy excess funds.

a. Unlikely to spend it on R&D

Though there may be more research spending forthcoming, current liquid balances are unlikely to go towards much more R&D or the adoption of new technology. Canada is notorious for spending a very small proportion of its overall gross domestic product on such activities and it is unlikely that this will change much overnight. Outside of a few clusters of research-intensive activity, there isn't much core R&D that goes on in the country (chart 11). Canada spends less than one-half of what Sweden spends on R&D relative to its economy. We spend much less than the United States and are well below the average of OECD industrialized nations.

Even if the talent, ideas and research focus were to become as prevalent in Canada as they are by Sweden's world leading standards, that extra 2% of GDP would amount to about C\$30 billion in extra R&D spending in Canada. That is only about 40% of the liquidity excess that we've estimated and a lofty target indeed.

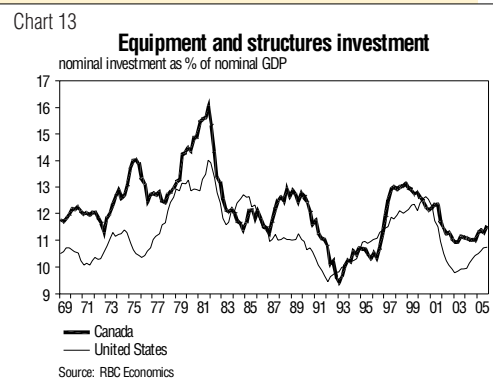
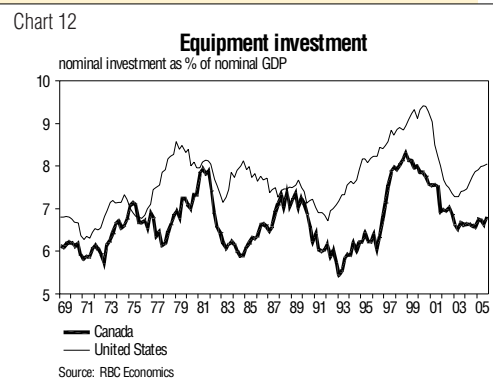
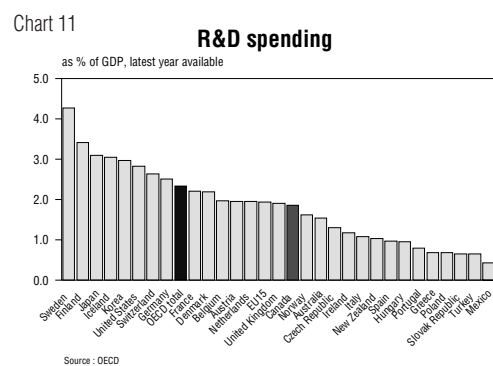
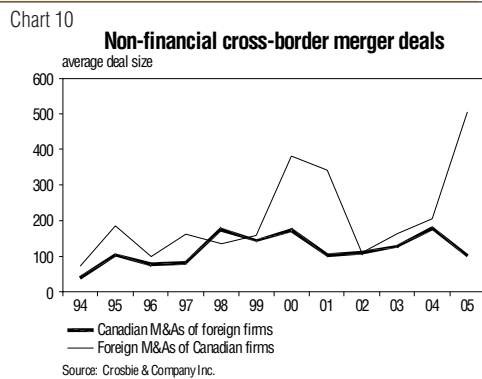
b. Too much to invest

Some of this liquidity will be ploughed back into businesses. After all, business investment in machinery and equipment grew by about 10% in each of the past two years. Also, investment in nonresidential structures — not all of which is done by businesses — grew by 7% last year. Canada has also consistently been outpaced by the United States on equipment investment (chart 12), though not for structures (chart 13), suggesting that Canada tends to put more workers in its structures and less equipment and technology. Hence, the seeds of a productivity challenge.

But, it is unlikely that all of this excess liquidity will be used for investment. In 2005, Canadian businesses invested about C\$91 billion in equipment and C\$64 billion in structures. If the C\$80 billion in excess liquidity were all put towards investment in machinery and equipment, that would fund 10% annual investment growth for about six and one-half years assuming no further internal cash flow generation, which is not plausible. Or, C\$80 billion could fund about 10 years of 10% growth in spending on structures. Using similar assumptions, U.S. companies could fund almost four years of 10% growth in equipment investment, or about nine years for structures. Such estimates would be highly aggressive. Also, according to Statistics Canada's latest survey of investment intentions, Canadian businesses have rather unimpressive investment plans for 2006 (chart 14).

c. Too much liquidity for preserving credit quality

In 2005, Canadian companies of all shapes and sizes spent just under \$50 billion on debt interest charges. Their interest coverage ratio — cash flow divided by interest



expense — stands at among the best levels in history. Since interest coverage is a good leading indicator of loan defaults and charge-offs (chart 15), an excellent standing on coverage helps explain why business loan loss rates are very low. But, it may be prudent to tuck away some cash for a rainy day as interest rates rise and profits peak.

Shareholders, however, do not pay companies to make risk averse asset allocation choices they can do more cheaply and effectively on their own. Further, the magnitude of the numbers is excessive. Last year, total interest expense at non-financial corporations grew by about 6% over the year before. The liquidity buffer presently on hand would fund 10 years' worth of 10% increases in the interest bill. In the United States, the same calculation yields an even longer 13.5 years. Such a trend would be unique, to say the least. What's more, the costs of maintaining a rainy day fund are rising. The direct cost of doing so will rise as inflation climbs during the next year such that negative after-tax and after-inflation returns on cash will only get worse. The opportunity cost of holding excess cash is also rising as interest rates climb.

d. Not for unfunded pension liabilities

Another plausible argument is that companies are hoarding liquidity to cover off unfunded liabilities, but we sure hope not. Hoarding cash for this purpose wouldn't make sense from a matching standpoint. Long-tailed pension liabilities should be funded by long-tailed assets. In any event, this is less of an issue for Canada than in some other markets like the United States. A recent study concluded that most Canadian industries, with the notable exception of autos, face a low probability of pension issues being a major factor in their ratings ("*Pension Plan Deficit More Manageable*," Dominion Bond Rating Service, October 2005).

VI. A role for all stakeholders

Our view is that M&A deals are a key way in which to shift the management of corporate finances more proactively towards overcoming challenges to Canada's competitiveness. This is true across many industries (chart 16). A strong short-run financial position can quickly give way to further erosions in our competitiveness if not utilized effectively. M&As don't always work, but their benefits are particularly unique to the current environment and must be evaluated in terms of alternative future outcomes for industry competitiveness in the absence of mergers.

The full burden of addressing these challenges rarely rests solely on management's shoulders in many world-leading economies. Companies face public policy growth barriers that partly work against liquidity redeployment [see *The Path to Prosperity*, RBC, October 2002]. They are, indeed, heavily overtaxed and face a growing burden of poorly designed and profit-insensitive taxes that must be reduced. They cannot source enough talent due to skilled labour shortages, unacceptable high school dropout rates, weak apprenticeship programs and underfunding at the post-secondary level, including management training. Infrastructure bottlenecks exist at ports, roads and highways, border crossings and in electricity markets.

Governments have a role to play in creating the conditions for liquidity redeployment to occur along productive lines through investment, skills training and R&D spending in contrast to inflationary uses. At risk is that all the money pumped into world markets by central banks in recent years and stockpiled on balance sheets risks being redeployed along inflationary paths. Reducing the barriers to growth is important in this regard.

