Valitas Insights

Four Trends That Will Shake up Canada’s Economy

2018 Canadian Business Outlook

By Topher Abt

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Synopsis

We look at how key activities are shaping up to impact the Canadian business landscape in 2018, from both a business owner and M&A perspective. Our review focuses on the following areas:

1. NAFTA Negotiations
2. U.S. Tax Reform
3. Interest Rate Environment
4. Energy Outlook

The Year Ahead

In case you missed it, our most recent publication reviewed Canadian M&A activity in 2017, a year that saw an abundance of deals nationwide and exhibited a near 10% uptick in transaction volume relative to 2016. This week, we look ahead to the rest of 2018, drawing on the insights of Pierre Ouimet, Executive Director and Head Investment Strategist at UBS Bank (Canada), to highlight key factors that we see impacting the Canadian business landscape in the coming months.

I. NAFTA Negotiations

Perhaps most relevant to Canadian business owners is the looming outcome of ongoing NAFTA negotiations, which kicked off in August 2017 and could carry into 2019 at this rate. The range of possible outcomes varies, and so too do the potential impacts on Canadian businesses.

i. Range of Outcomes – Who Stands to be Impacted?

The best-case scenario from a Canadian standpoint would likely see the existing agreement amended, with marginal increases to existing tariffs. Even marginal increases to tariffs, though, would result in a downward impact on trade-sensitive sectors.

Take the automotive manufacturing industry for example, where parts are sourced throughout North America and can cross the border multiple times during different stages of production. A tariff increase on auto parts would see each part taxed an incremental amount each time it crossed the border, meaning that even a small tariff hike could have a compounding impact on the cost of production and downward impact on U.S.-based demand for Canadian auto parts.

An alternative scenario could see NAFTA ripped up altogether. The impacts of this would hinge on the system of tariffs taking NAFTA's place, of which there are a range of possibilities. Some suggest that a reversion to the currently-suspended Canada-United States Free Trade Agreement of 1987 would occur, while others surmise that the countries would adopt the moderately higher tariff levels of the World Trade Organization (WTO), while more pessimistic pundits envision an extreme scenario of large tariff hikes. Under any of these scenarios, and particularly the latter two, Canadian businesses with significant revenue from exports to the U.S. could find themselves hard-pressed to compete with U.S.-based competitors. This turn of events would have far-reaching impacts on Canadian businesses, especially when we consider the following:

Exports alone contributed nearly 32% to Canada's US$1.53 trillion GDP in 2016, with US$296.5 billion (76% of all exports) billion accounted for by the U.S.

ii. Uncertainty Will Deter Capital Investment in Canadian Businesses

While the effects of replacing NAFTA would likely not be felt in 2018 due to complexities of withdrawing from the agreement (i.e. six-month withdrawal notice period followed by extensive legal proceedings), the uncertainty created by ongoing negotiations will be felt in the short term, as Canadian business owners and foreign investors nervously wait to see what will transpire. This environment of uncertainty will undoubtedly have a negative impact on the amount of money invested into Canadian businesses by Canadian nationals and foreigners alike.

As Mr. Ouimet points out, "When it comes to NAFTA, things will likely get worse before they get better, and that will create some uncertainty. Why would anyone abroad invest in Canada right now not knowing what trade relations will look like going forward? And similarly, why would Canadian business owners invest significantly right now if they don't know the rules of the road ahead, particularly if they are an exporter?"

iii. Uptick in Cross-Border Acquisitions by Canadian Companies

One interesting trend to keep an eye on amid ongoing NAFTA negotiations is the potential for an uptick in cross-border acquisitions of U.S.-based targets by Canadian companies. Expanding operations into the U.S. represents a potential safeguard for Canadian companies concerned with the uncertainty of future trade relations with their U.S. neighbours. With the Canadian economy going strong and the additional incentive to establish U.S. operations, we expect there to be a healthy appetite for U.S. acquisition activity among Canadian buyers.

On this note, we asked Mr. Ouimet whether he foresees an increase in Canadian companies setting up shop south of the border, either through organic expansion or acquisition, to which he responded:

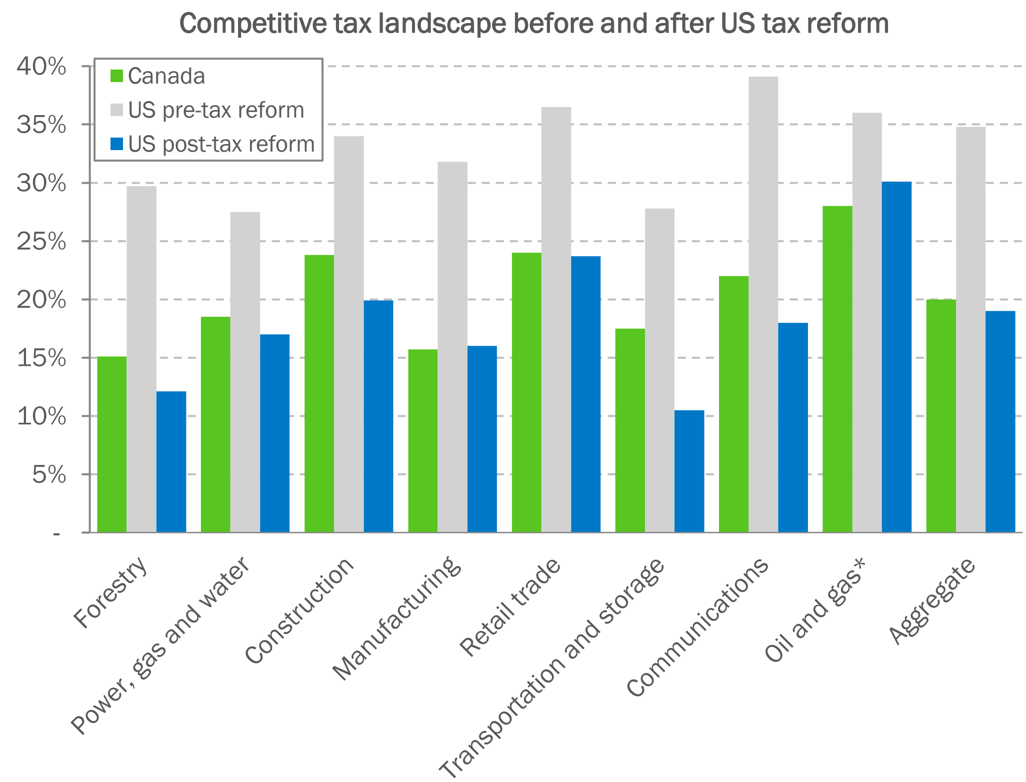
"That's already happening. If you're a regional company in Canada, it makes more sense to expand south than east or west, generally. Looming changes to trade relations and the recent U.S. tax reform will only exacerbate this trend."

II. U.S. Corporate Tax Reform

The sweeping changes brought about by the US Tax Cuts and Jobs Act have dominated headlines over the past month, and its implications will surely be felt by Canadian businesses. Most notably, the U.S. federal corporate tax rate has been slashed to 21% from its previous level of 35%. Additionally, for a limited time, companies with international operations will be allowed to repatriate cash earned (and held) overseas at a comparably favourable rate of 15%, compared to 35% previously. How will this impact Canadian business owners?

i. Attractive Tax Environment Will Shift Investment Toward the U.S.

For starters, the competitive advantage Canadian businesses enjoyed on taxes over the past decade is gone. As of January 1st, the marginal effective tax rate (METR) burden on U.S. corporations has not only fallen in line with the METR incurred by Canadian corporations, but in many cases is now lower. The graphic below compares the METR of Canadian and U.S.-based corporations broken down by sector.



Source: P. Bazel and J. Mintz, School of Public Policy, University of Calgary
**Oil and gas is not included in aggregate result*

So, U.S. companies no longer pay significantly higher taxes than Canadian companies – why does this matter? Well, companies with international operations are now more likely to deploy capital in the U.S., which will inevitably lure investment away from the Canadian market. Under the previous laws, many companies viewed investing in tax-friendly Canada as an attractive means of setting up shop in the North American market. But with the disappearance of Canada's comparatively favourable tax environment, we can expect to see a corresponding dip in the amount of foreign capital invested in Canadian business operations, as well as a decline in the skilled labour associated with that capital investment.

Mr. Ouimet echoed this sentiment in saying, "It is likely that we will see an increasing number of companies invest in the U.S. as opposed to abroad. Traditionally, we have seen companies investing in Canada to access the U.S. market. Now, with favourable U.S. corporate tax policies in place, we will probably start to see that capital investment trend swing in favour of the U.S."

ii. Increased Corporate Cash Balances Will Drive M&A Activity

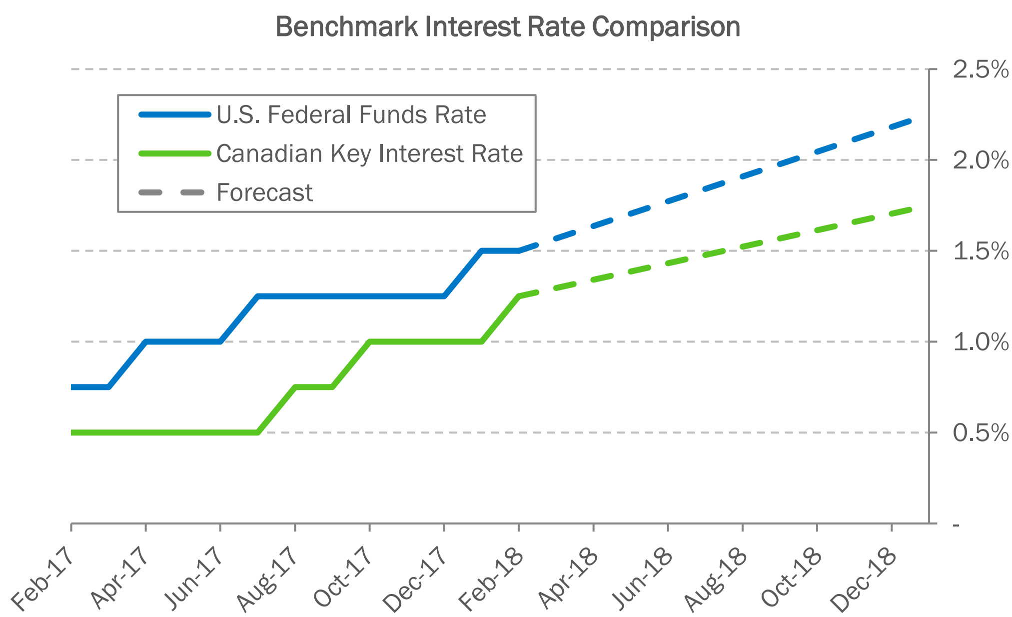
U.S.-based companies are about to see their cash balances increase, and with this so too will their financial firepower for M&A activity. The combined effect of the reduced federal corporate tax rate and the ability to repatriate foreign cash at significantly reduced rates is that U.S. companies should see a substantial increase in the amount of cash on their balance sheets.

Take Apple, for example, who has already announced plans to repatriate over $200 billion in foreign cash. This influx of cash will bolster corporate balance sheets in an already healthy American economy, and should help drive American acquisitions of both domestic and foreign targets, Canada included.

III. Interest Rates and Canadian Dollar Depreciation

We are currently in a period of rising interest rates. The U.S. federal funds rate currently sits at 1.5%, up a full percentage point from its mark of 0.5% in late 2016, while the Canadian key interest rate rests at 1.25%, up three-quarters of a percentage point since mid-2017.

With the U.S. federal rate expected to see another 3 or 4 hikes by year's end and the Canadian key rate is expected to rise 2 or 3 times over the same period, how will Canadian business owners be impacted?



i. Increasing Cost of Borrowing – Who Gains? Who Loses?

Rising interest rates mean that in general borrowing will become more expensive. As the respective federal rates rise, so too do the prime lending rates of banks. While the current prime rate of 3.45% offered by Canadian banks is still low on a historical basis, the steadily rising rate poses a potentially onerous challenge for Canadian businesses, especially those beleaguered by heavy debt loads.

And small businesses too, particularly those relying on cheap, readily available debt as a source of funding, will feel the impact of continued interest rate hikes. At the end of the day, the cost of an interest rate hike comes directly out of profits, meaning small businesses with modest bottom lines stand to feel the brunt of these hikes.

How about the impact on private equity firms, who use significant amounts of debt (typically greater than 50% of purchase price) to fund acquisitions? In short, it's an unwelcome trend for private equity buyers. Rising interest rates mean that the interest payments associated with debt increase, leading to lower profit margins. For new investments, a higher cost of debt means the weighted average cost of capital (and thus, the perceived risk) will be higher, meaning investors will expect higher returns for staking down their money.

Other players in the financial sector, meanwhile, stand to benefit in this environment of rising rates. Banks, insurance companies, and brokerage firms welcome rate hikes with open arms, as rising rates point to a strengthening economy wherein borrowers are more trustworthy and spreads on loan arrangements are increasing.

ii. Depreciating Dollar? Good News for Exporters

Some pundits are forecasting the Canadian dollar to experience a devaluation in 2018. Interest rate dynamics, NAFTA uncertainty deterring investment in Canadian businesses, and the potential for a decline in oil prices could combine to have a depressive effect on the Canadian dollar before 2018 is out.

The U.S. fed rate is expected to rise more significantly and rapidly than its Canadian counterpart over the remainder of 2018, which will put downward pressure on the Canadian dollar. NAFTA uncertainty will continue to deter investment in Canadian businesses over the short term which will reduce demand for and devalue the Canadian dollar. Finally, the wildcard that is global oil prices could pressure the Canadian dollar downward in the event of a price dip, or contrarily, upward in the event of a price increase.

NAFTA concerns aside, a depreciating Canadian dollar would bode well for Canada's export-oriented sectors such as energy, materials, and industrials. A weakening Canadian dollar would boost demand for exported products, thus driving healthy growth across export sectors. Canada's import-sensitive sectors meanwhile, such as telecom and consumer staples would shoulder increasing costs of goods sold in a depreciating Canadian dollar environment.

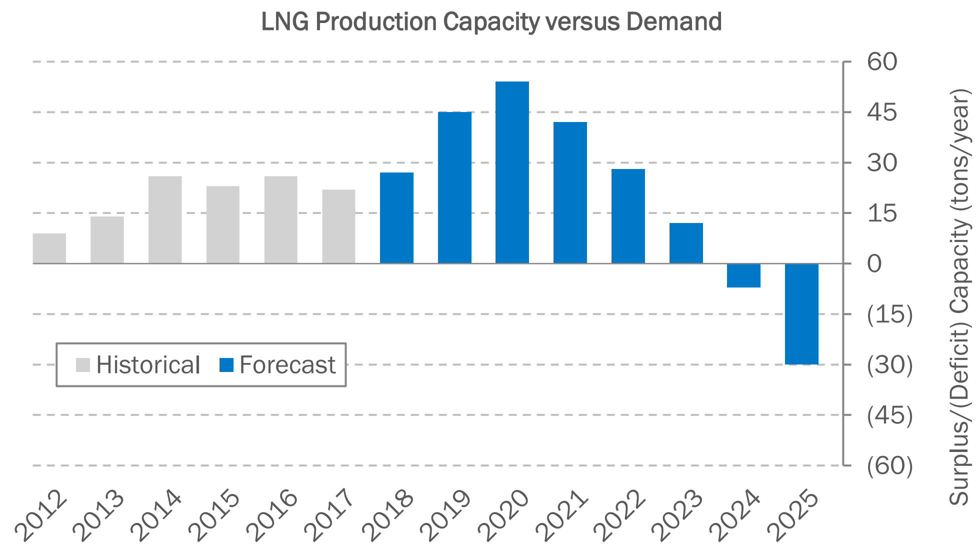
IV. Canada's Energy Outlook – Tough Regulatory Environment

Finally, we look at one of Canada's most vital sectors—energy, with thoughts from Mr. Ouimet on the prospects of Western Canada's economic engine.

"The regulatory and political environment will weigh heavily on the Canadian economy, particularly in the energy sector."

i. Natural Gas Outlook

Canada's energy industry has stumbled over regulatory roadblocks for the past few years in its bid to become a global competitor in the liquified natural gas (LNG) space. Global demand for natural gas, the cleanest fossil fuel, has surged in recent years, with Chinese imports of LNG spiking 39% last year. And following last year's 10% increase in global LNG demand, the outlook remains positive, with demand expected to rise 4-5% per year until 2030. With key Asian markets, led by Japan, India, and China, projecting robust demand for LNG in the years ahead, Canada is well-positioned to address this growing market need given its geographical proximity and abundance of natural gas. An estimate provided by Sanford C. Bernstein & Co. projects that 30 million tons of new LNG capacity is needed to meet 2025 demand.



There's only one issue… Canadian natural gas is landlocked with no means of reaching foreign markets. This past year saw the cancellation of two monumental LNG infrastructure projects aimed at opening the gates to the global market for Canadian natural gas producers—Nexen's $28 billion Aurora LNG project and Petronas' $36 billion Pacific Northwest LNG project. After years spent planning and seeking approval from regulatory bodies at the local, provincial and federal levels, decision makers at the respective oil giants pulled the plug on their projects, both citing downturns in market conditions.

The "market conditions" being referred to are global LNG prices, which at the time were soft due to surplus supply. This surplus supply is partly driven by foreign competitors, like Australia, Russia and the U.S., who have all scaled up LNG export capabilities while Canada's proposed LNG projects have languished.

Australia, for its part, has brought five US$15+ billion LNG facilities online since the start of 2014, with Inpex's US$34 billion Ichthys LNG project and Shell's US$12+ billion Prelude floating LNG (FLNG) project both slated to come online this year.

Meanwhile, the U.S. brought their first LNG export facility (Cheniere Energy's Sabine Pass) online in early 2016, and another five LNG projects are expected to come online by the end of 2019.

And then there's Russia, who just jointly launched a $27 billion LNG facility in the Arctic circle and has aims on surpassing Qatar as the world's leading LNG exporter. As for Mr. Ouimet's thoughts on the matter:

"Americans will have gone from 0 to 9 trillion cubic feet per day in LNG exports by the end of 2019. The Russians are building huge LNG export facilities. Australia is becoming a global leader. And meanwhile, Canada remains at the mercy of local supply and demand."

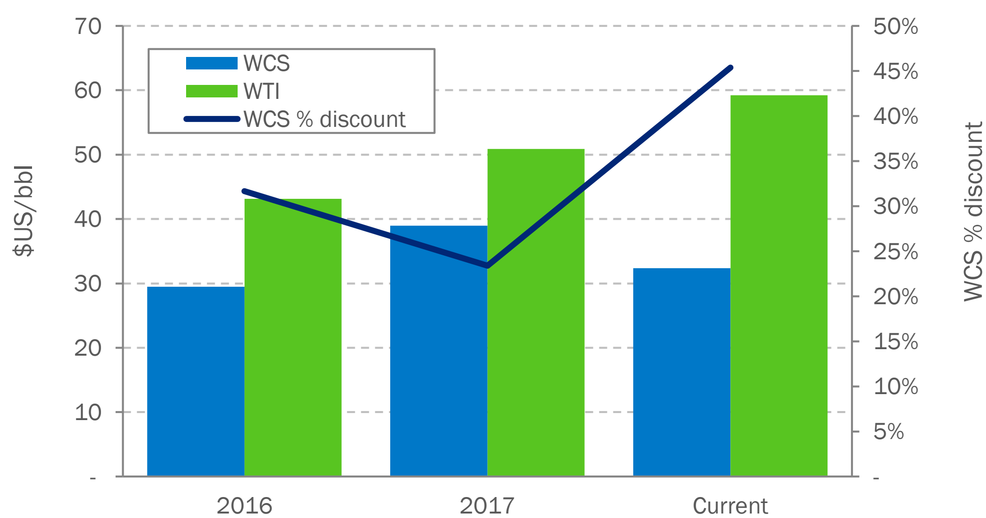
All this activity, paired with a stagnant Canadian LNG landscape, prompted the National Energy Board to declare Canada as a "late entrant to the global LNG market," while emphasizing that "the next several years are critical to the development of the Canadian LNG industry." With global LNG prices rebounding since last June and strong Asian demand on the horizon, 2018 is shaping up to be a critical year for Canada's LNG future – one that largely hinges on the success of LNG Canada, a C$40 billion development led by Shell. While late to the party, it remains to be seen whether Canada can take advantage of the next wave of global LNG demand as countries like China shift towards natural gas a primary energy source.

ii. Oil Outlook

Mr. Ouimet: "There are issues with heavy oil pricing in Canada, staggered by a lack of access to markets."

The narrative for Canadian oil shares similarities with the story on natural gas. Canadian oil producers are often subject to the mercy of domestic demand, squeezed by a lack of pipeline capacity to foreign markets. This results in the Canadian oil benchmark, Western Canada Select (WCS), trading at a steep discount to its U.S. counterpart, West Texas Intermediate (WTI), which ultimately slashes profits and exacerbates losses for Canadian producers.

Average Canadian Oil Benchmark Discount to U.S. Benchmark



Alberta's lack of pipeline capacity to the U.S. was emphasized in November, when an outage on the Keystone pipeline in South Dakota sent WCS prices cratering south of US$30/barrel, a near $30 differential to the WTI. Efforts to expand export capacity through pipeline extensions have been rebuffed over environmental concerns. Most recently, Energy East, a TransCanada-backed project that would have carried crude oil from Western Canada to refineries and ports in New Brunswick, was scrapped amid increasing regulatory scrutiny.

With Alberta set to ramp up production through new developments, such as Suncor's Fort Hills project, and little relief on the horizon in the form of increased pipeline capacity, prices are expected to continue to suffer. There are a few major pipeline projects in the works, such as TransCanada's Keystone XL and Kinder Morgan's Trans Mountain, but neither of these projects are imminent and relief will not be coming any time soon. Facing inadequate pipeline capacity, producers have been forced to use rail as a means of getting oil to market, which has resulted in a suppressed price for WCS that we can expect to see until action is taken to enhance Canada's export capacity.

V. Conclusion

Buckle up for the year ahead. It's a crucial one for Canadians. Between the outcomes of the ongoing NAFTA negotiations and proposed energy infrastructure projects, the Canadian economy and business owners alike have a lot riding on the next 10 months.

NAFTA negotiations, for as long as they drag on, will continue to hold Canadian business investment hostage as nervous investors play the waiting game to see how future trade relations with the U.S. will shape up. Meanwhile, capital investment in the U.S. is sure to be strong with the combined effects stemming from the Tax Cuts and Jobs Act, including a reduced federal corporate tax rate, incentivized foreign cash repatriation, and immediate expensing of short-lived capital investments.

Cross-border M&A activity with the U.S. should be robust as Canadian corporations, particularly exporters, consider expanding operations into the U.S. as a preemptive move to what a post-NAFTA world could look like. Furthermore, U.S. companies flush with cash from the effects of the Tax Cuts and Jobs Act should drive increased M&A activity.

A stifling regulatory environment in Canada's energy sector could have far-reaching impacts that would be felt for decades to come. Contrarily, if major industry players can find common ground with regulators and break ground on cornerstone infrastructure projects to unlock access to rapidly growing foreign markets, we could expect to see positive, resonating effects on the Canadian economy.