Valitas Insights

A Healthy Economy That's Stuck in Neutral

2018 Canadian Business Q2 Update

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June 2018

Synopsis

We look at how key activities impacted Canadian business activity during the first quarter, while also considering how these activities will affect the Canadian business landscape over the remainder of 2018. Our review focuses on the following areas:

1. NAFTA Negotiations
2. U.S. Tax Reform
3. Energy Outlook & Regulatory Challenges

The Rest of 2018

Back in early-March, we teamed up with Pierre Ouimet, Head Investment Strategist at UBS Bank (Canada), to put together our *Annual Outlook* on the Canadian economy. The report covered a range of topics pertinent to Canadian business owners, from ongoing NAFTA negotiations to the sweeping reform brought about by the U.S. Tax and Jobs Act. A few months later, we've checked back in with Mr. Ouimet to discuss the quarter that was, while also considering issues that stand to impact the rest of 2018.

I. NAFTA Negotiations

i. Stuck in Traffic

Canadian business owners, along with their American and Mexican counterparts, continue to wait as negotiators struggle to find common ground on the future of North American trade relations. What's the hold up? The automotive industry - which negotiators have been haggling over since October.

U.S. officials initially tabled a proposal requesting that North American-built vehicles contain at least 85% content made in NAFTA countries, a significant bump from the current level of 62.5%. The proposal also stipulated that 50% of this content be sourced from the U.S., all part of President Trump's aim at reducing the U.S. trade deficit. Mexico and Canada pushed back on this request, however, arguing that the targets were too lofty and actually counterproductive to President Trump's goal of bringing manufacturing back to the United States, a notion supported by this April report released by the Center for Automotive Research.

In mid-March, the U.S. reportedly softened its stance on rules of origin requirements, renewing optimism that a deal could be reached. However, the three countries remain divided on the issue of wage levels, with the U.S. reportedly demanding that at least 30-40% of every vehicle be produced in a high-wage country. Mexico supposedly shot this proposal down, citing the damage it would inflict on its auto parts industry, where low-cost labour represents a competitive advantage that has been key in attracting foreign investment. And so, as of this writing, negotiations remain at an impasse.

And the debate on auto parts is just one hurdle. There's a laundry list of other topics that the countries have yet to reach agreements on.

There's still the 5-year sunset clause U.S. negotiators are supposedly after, wherein NAFTA would expire after 5 years unless all three countries mutually agree to extend the agreement. If the objective of the agreement, among other things, is to instill *long-term* confidence in facilitating free trade and capital investment among member countries, then an opt-out clause after 5 years seems utterly illogical. There's also the Chapter 11 investor-state dispute resolution system that the U.S. is looking to abolish, but Canada has yet to relent on this point despite having lost over $300 million due to its existence.

In short: there's a lot of work to be done. And the clock is ticking.

ii. Up Against the Clock

> ***"Either a deal gets done by the end of June, or there's a good chance an agreement will not be completed in 2018."***

This seems to be the consensus among observers, as NAFTA dealmakers are up against a few deadlines.

First, there are the contentious steel and aluminum tariffs that the U.S. government has introduced and threatened to implement if it doesn't get a NAFTA deal to its liking. Ultimately, the Trump Administration is aiming to limit excess Chinese supply, effectively boosting global prices and driving increased U.S. production. Simply slapping tariffs on Chinese imports would not achieve this though, since other steel- and aluminum-producing countries would step up to fill the supply void. For this reason, the U.S. is applying these tariffs to a wide range of countries.

Mexico and Canada managed to dodge the tariffs until June 1st through a series of exemptions extended by the U.S. The most recent exemption expired on June 1st, however, at which point 25% and 10% tariffs kicked into effect on steel and aluminum imports, respectively. With Canada being the number one supplier of both aluminum and steel to the U.S., there is urgency among Canadian exporters to achieve a trade deal quickly.

And now, the U.S. is threatening to enact 25% tariffs on Canadian-made autos. Flavio Volpe, President of the Automotive Parts Manufacturers' Association, warns that the threat of U.S. tariffs on Canadian-made autos would have a decimating impact on both sides of the border.

> ***"A 25 per-cent tariff on cars and parts would cause what we like to call a Carmageddon . . . The economic stability of Ontario is at risk [and these measures would send at least seven U.S. states into recession.]" – Flavio Volpe, President, Automotive Parts Manufacturers' Association***

If a deal isn't in place by July, things stand to get even more complicated. The Mexican presidential election will be held on July 1st, and the U.S. midterm elections hit full swing as the calendar moves into the fall.

It's looking as though Mexico is destined for a significant leadership shake-up, with left-wing populist Andrés Manuel López Obrador leading the polls by a wide margin. López Obrador's team has gone on record as saying that they would respect a new NAFTA agreement in place prior to his election. However, if a deal isn't made before July 1st, this would undoubtedly complicate NAFTA discussions as the new Mexican administration would seek to roll out its own agenda.

The U.S. midterms, scheduled for November 6th, could also complicate things. With all 435 seats in the House of Representatives and 35 of the 100 seats in the U.S. Senate up for election, the possibility exists that either of these bodies, both presently controlled by the Republicans, could see a swing in representation. A renegotiated NAFTA would need to clear both the House and Senate with majority approval; thus, a House or Senate controlled by Democrats could stand in the way of the Trump Administration's desired reforms. Congress requires 180-days notice to approve changes to NAFTA. So, while a renegotiated agreement won't be ratified before the November mid-term elections, there is urgency among Trump's representatives to hammer out a preliminary agreement before election season to bolster the Republican ticket.

What do all these competing interests and pressing deadlines mean for the future of North American trade relations? Well, *nobody seems to know for certain*, and therein lies the problem for Canadian business owners.

iii. Uncertainty is Deterring Investment

> ***"Between NAFTA, regulatory headwinds, and the impact of U.S. tax reform, Canada will struggle to attract fixed investment in the short-term." – Pierre Ouimet, UBS (Canada) Head Investment Strategist***

The uncertainty shrouding the Canadian economy has started to take its toll. The Bank of Canada's *Spring Business Outlook Survey* indicates that positive sentiment has started to wane at the corporate level, with businesses feeling increasingly pessimistic or uncertain about the potential impact of U.S. policy changes over the past year.

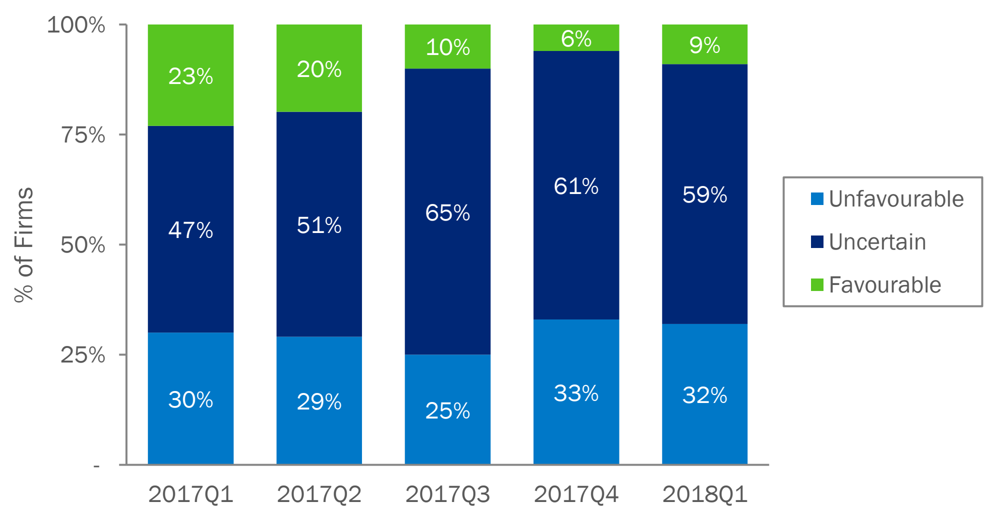

Figure 1: Result of Canadian firms polled on the impact of U.S. policy changes or associated uncertainty on business performance over the next 12 months

How has this climate of ambiguity impacted Canadian business investment? In our *Annual Outlook*, Mr. Ouimet questioned why Canadian business owners would invest significantly right now without knowing the rules of the road ahead. This notion is supported by Bank of Canada Governor Stephen Poloz, who in a recent BNN interview, acknowledged that "there is no question that the uncertainty [of ongoing NAFTA negotiations] is already playing a role" in depressing Canadian business investment. The extent to which investment is being deterred is tough to gauge since there is no explicit measure around "whether [Canadian businesses] are putting off investments or reconsidering whether investments should be made in Canada or elsewhere."

Statistics Canada's annual report on capital expenditure sheds light on the issue of capital investment. The report's first headline reads "*Capital spending intentions up for 2018*," which at face value is true. Capital spending in Canada is projected to hit $238.6 billion in 2018, up a sliver from $236.7 billion in 2017. A quick Google search will pull up a handful of articles touting Canada's increasing level of investment in the face of uncertain circumstances. This is misleading though. What's telling is that while the public component of capital expenditure has been trending upwards since 2014, the private component has been trending downwards.

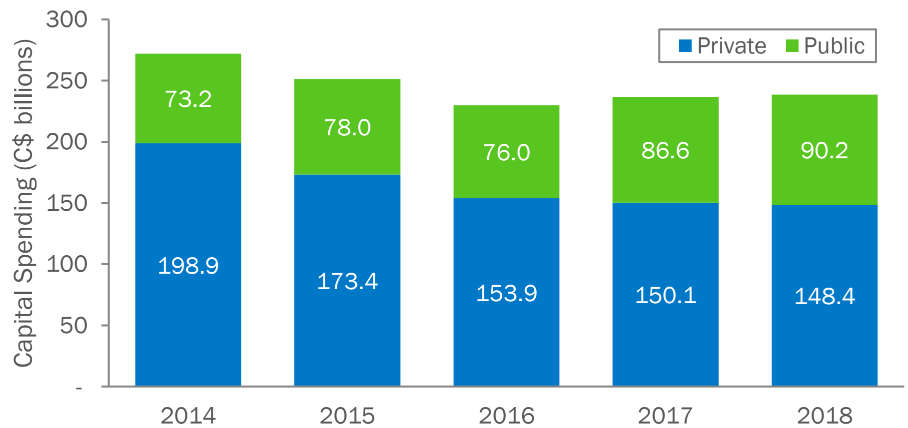

Figure 2: Breakdown of capital spending in Canada by private and public investment

Now, it makes sense that private investment dipped in 2015 and 2016 amidst cratering oil prices before flattening off in 2017 as companies restored health to their balance sheets. However, with oil prices on the upswing since early-2016 and the Canadian economy coming off a robust 2017, you would expect to see private investment back on the upswing. But with private capital investment projected to edge downwards again in 2018, we remain convinced that Canadians are nervous… and for good reason. Canada needs its leadership to step up and deliver certainty to its economic future.

II. U.S. Corporate Tax Reform

i. Corporate Juggernauts Driving U.S. M&A Activity

In our Annual Outlook, we discussed at length the impact that the U.S. Tax and Jobs Act would have on North American M&A activity, predicting that increased corporate cash balances would fuel acquisitions among large U.S. corporations.

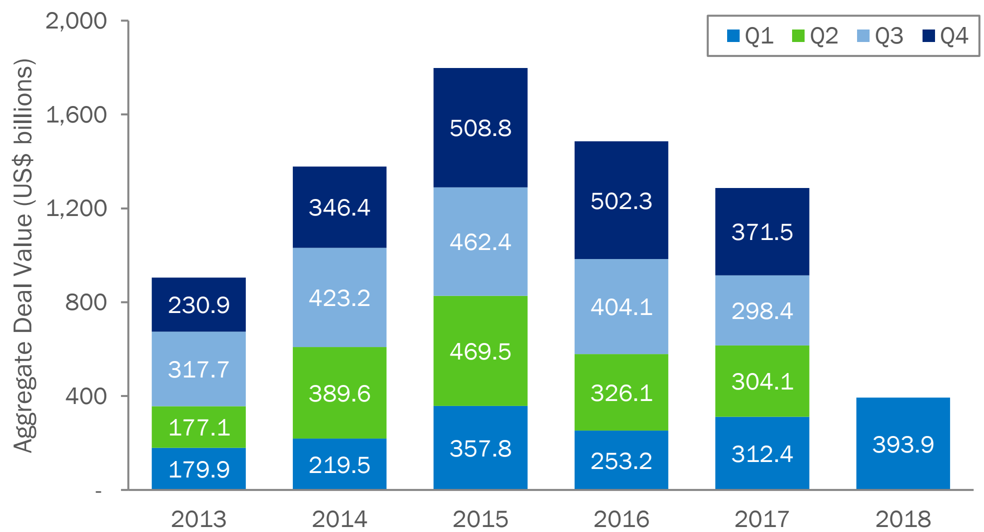

Figure 3: Quarterly breakdown of reported U.S. M&A activity[1,2]

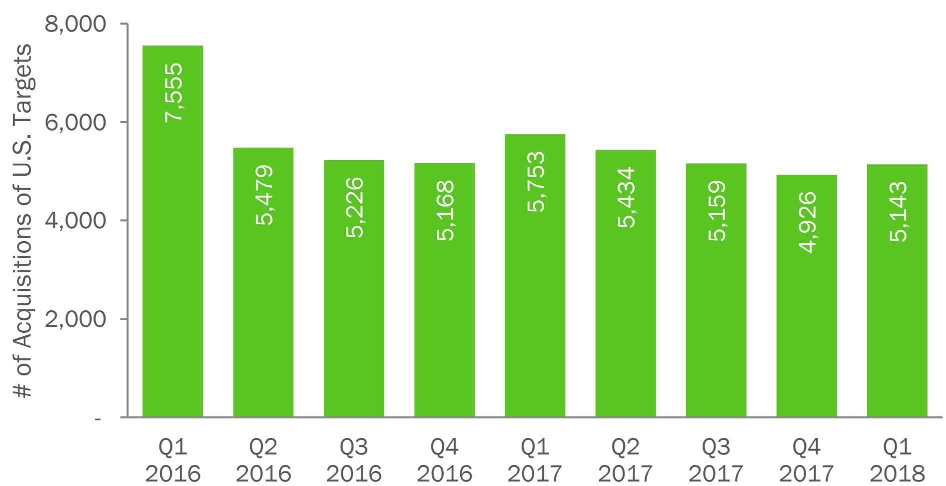

Figure 4: Quarterly M&A count in the U.S.[3] (as measured by target location, all transaction sizes)

The early returns support that notion, as the first quarter was characterized by a slew of six U.S. megadeals in excess of $10 billion, led by Cigna's $67.9 billion acquisition of Express Scripts. On the strength of these megadeals, the aggregate value of U.S. deals increased 26% to $393.9 billion in Q1 2018 from $312.4 billion in Q1 2017.

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[1] Mergermarket, 2018 Q1 Global & Regional M&A Report Q1 2018
[2] Deal criteria: transactions involving U.S. target with deal value exceeding US$5 million or target turnover exceeding US$10 million
[3] Source: Zephyr published by Bureau van Dijk, Global M&A Review Q1 2018

Deal count in the U.S., meanwhile, irrespective of transaction size, slipped 11% from 5,753 in Q1 2017 to 5,143 in Q1 2018, implying that the average transaction size increased substantially. Overall, these trends support the idea that large U.S. corporations flush with liquidity have ramped up their acquisition efforts.

ii. Canadian M&A Activity Ice Cold Amidst Uncertainty

By comparison, M&A activity in Canada was rather tepid in the first quarter, as companies continue to quarrel with an uncertain political and regulatory environment.

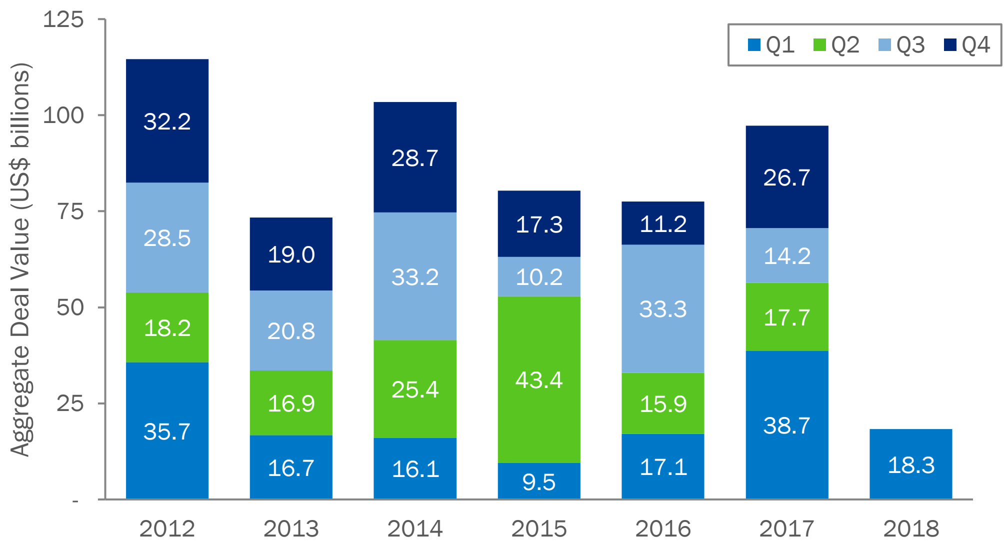

Figure 5: Quarterly breakdown of reported Canadian M&A activity[4,5]

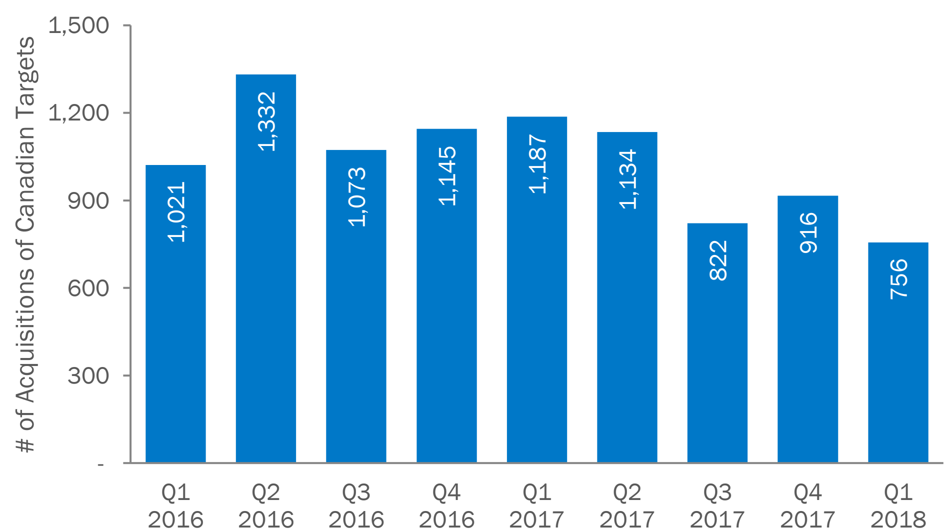

Figure 6: Quarterly M&A count in Canada (as measured by target location, all transaction sizes)

[4] Source: Mergermarket, Q1 2018 Canada Regional Trend Report
[5] Deal criteria: transactions involving Canadian target with deal value exceeding US$5 million or target turnover exceeding US$10 million

The aggregate value of Canadian deals slumped to $18.3 billion in 2018 Q1 from $38.7 billion in 2017 Q1, a decline of 53%. While a 53% drop in deal value seems significant, this should be taken with a grain of salt, since in the relatively smaller Canadian market one or two megadeals can account for a majority of the aggregate deal value in a quarter. For instance, Cenovus' $13.2 billion acquisition of ConocoPhillips' oil and gas assets in Q1 2017 is one of only 20 Canadian megadeals (>$10 billion) on record and dwarfs the largest acquisition of a Canadian company in Q1 2018, Choice Properties REIT's $4.6 billion acquisition of CREIT.

What's more telling about the Canadian M&A picture this quarter is the overall deal count, which shows that the number of transactions completed fell 36% from Q1 2017 to Q1 2018, from 1,134 to 756. The sharp decrease in Canadian deal count most likely reflects the hesitance of business executives and investors to make critical investment decisions in an uncertain Canadian business environment.

iii. What to Expect the Rest of the Year?

It's fair to say that Canadian M&A activity has fallen short of expectations thus far in 2018. The consensus heading into 2018 seemed to be that M&A activity would build on a strong 2017, bolstered by strong economic fundamentals in Canada and recovering oil prices. However, with Canadian M&A activity sputtering to its lowest quarterly mark (by deal count) in over 2 years, it appears market observers may have underestimated the bearing of geopolitical and regulatory risks on investment decisions.

There is reason for optimism though. The "strong fundamentals" that buoyed expectations heading into 2018 are still present. Healthy credit spreads, modest inflation near the Fed's target rate, and robust levels of manufacturing and employment suggest the economy is primed for continued growth. With economic growth comes an increase in corporate earnings and an appetite for M&A activity.

Now, if only we could give investors and business owners reason to feel good about Canada's economic future. But until we have clarity on NAFTA and the viability of significant capital projects, it's likely that Canadian businesses will not reap the full benefit of a healthy underlying economy and an energized buyer universe south of the border. Our expectation is that M&A activity, as measured by deal count, will remain lukewarm in Canada until we have a clear vision of the road ahead.

iv. Canadians Calling for Review of Tax Policy

> ***"U.S. tax reform is already showing to be a game-changer for investment… and it hurts Canada in the long-term." – Pierre Ouimet, UBS (Canada) Head Investment Strategist***

In our *Annual Outlook*, we touched on how the U.S. Tax and Jobs Act would effectively reverse the competitive tax advantage that Canadian businesses enjoyed for over two decades. Previously, tax-friendly Canada represented an attractive means of accessing the North American market for foreign corporations and investors. But now, with the marginal effective tax rates faced by American corporations being less than the comparable Canadian rates, the U.S. economy is luring foreign investment away from Canada. This remains a pertinent issue—one that must be addressed if Canada hopes to remain competitive in the long-term. The impact of a less competitive investment environment would not be a sudden exodus of capital from the Canadian market, but rather a gradual withdrawal as businesses turn to superior investment opportunities in the U.S.

Tax policy will be an interesting topic to monitor as we move towards the 43rd Canadian federal election in the fall of 2019. Will Justin Trudeau's office respond to appeals from business executives asking the government to reconsider Canada's tax laws, or will the Conservative Party point to tax reform as a pillar of their election platform, citing its potential to restore international competitiveness to the Canadian economy?

III. Energy Outlook and Regulatory Challenges

> ***"Canada has enormous oil and natural gas resources. We have an opportunity to meet growing global demand in an environmentally and socially responsible manner. But this can only be achieved if Canadian oil and natural gas remain competitive and able to attract investment and spur innovation." – Canadian Association of Petroleum Producers, April 2018***

i. Rising Oil Prices and A Tale of Two Countries

What a difference a couple of months can make for industry sentiment. As recently as late-March, industry executives were bemoaning the lack of competitiveness in the Canadian oil industry and their inability to attract investment, citing Canada's near-impossible regulatory environment.

Global and Canadian oil prices have risen considerably since the start of 2018, ushering in a renewed sense of optimism to a Canadian energy sector that has been stifled by regulatory paralysis in recent years. The S&P/TSX Capped Energy Index, which tracks the performance of Canadian energy stocks, has increased 18% since early-February, bringing a nostalgic sense of hope to oil industry participants reminiscing on the days of $100 oil.

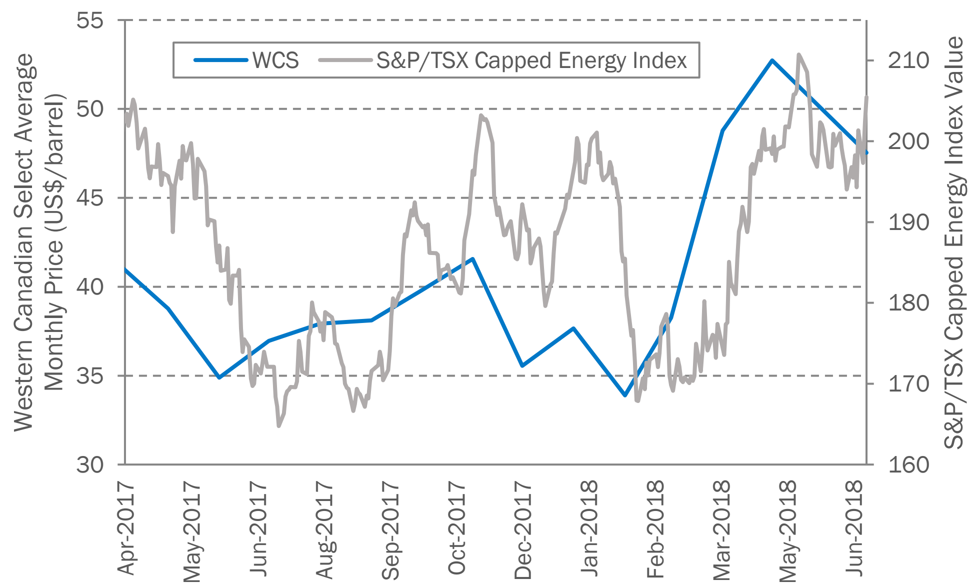

Figure 7: Price of Canadian benchmark oil (WCS)[6] and performance of Canadian energy stocks[7] over the past year

Increased global oil prices are great but do little to improve the long-term competitiveness of the Canadian energy industry. The issue plaguing Canadian oil and causing it to trade at a significant discount to American oil is still entirely prevalent. Pipeline capacity is inadequate and Canadian oil producers cannot get

[6] Source: Statista
[7] Source: CapitalIQ

their products to market. To restore competitiveness to domestic energy producers, Canada requires capital investment in the infrastructure that delivers energy products to foreign markets. This is hardly breaking news, but the longer this state of inaction grips the Canadian energy sector, the greater the competitive deficit will become.

Consider this: at a time when capital investment among global energy companies is ramping up, investment in the Canadian oil and gas industry will drop to its lowest level since the 2008 recession. By contrast, investment in the U.S. oil and gas industry is set to grow by 40% for the second consecutive year, highlighting the disparity of two countries heading in opposite directions.

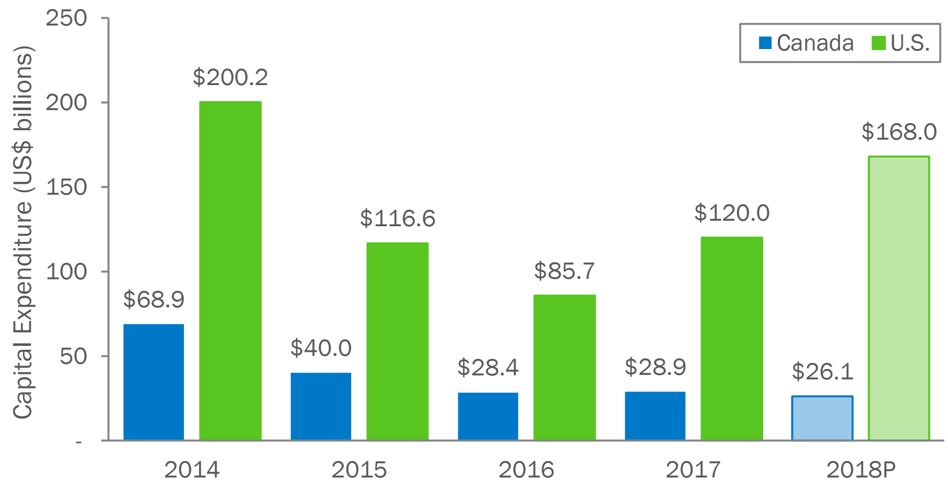

Figure 8: Annual breakdown of capital expenditure (US$ billions) in the oil and gas industry in Canada[8] and the U.S.[9]

ii. Good News Amidst Regulatory Headwinds

The escalating battle over Kinder Morgan's proposed $7.4 billion Trans Mountain pipeline extension is the latest dispute in what has become a disheartening effort to improve Canada's competitive position among global oil and gas producers. The proposed expansion would triple the pipeline's existing capacity and provide Western Canadian oil producers with increased access to Asian and Californian markets, unleashing a tremendous amount of currently wasted value.

Frustrated with the opposition it has faced from B.C.'s NDP government, Kinder Morgan decided to halt construction in early-April, threatening to pull the plug on Trans Mountain altogether if it wasn't given clearance to proceed by May 31st. On May 29th, in a last-minute move to salvage the project, the Canadian government announced its plans to acquire the project from Kinder Morgan for $4.5 billion, with additional construction costs to be incurred in order to complete the project.

The Canadian government's move to acquire the Trans Mountain project has been met with mixed reactions in the energy sector. Some industry executives have

[8] Source: Statistics Canada, Capital and Repair Expenditures Report (2018)
[9] Source: Canadian Association of Petroleum Producers, A Global Vision for the Future of Canadian Oil and Natural Gas (2018)

expressed relief that the project is now likely to move forward, while others have questioned what this signals to investors about the viability of private investment in Canada's oil and gas industry. So, while this move certainly improves the chance of the pipeline being completed, the resonating effect on investor confidence is uncertain. All in all, it's a bittersweet win for the Canadian energy sector. With the project estimated to deliver nearly $47 billion in revenue to the Canadian economy over its first 20 years, the importance of this project proceeding cannot be understated.

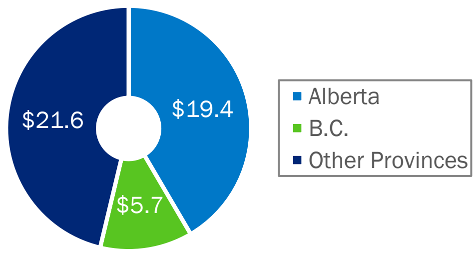

Figure 9: Expected increase in revenue to Canadian provinces over first 20 years following Trans Mountain pipeline expansion (in C$ billions)

In another dose of good news, Andy Calitz, CEO of LNG Canada, a joint venture led by Shell, recently stated that LNG Canada was committed to breaking ground on its $40 billion natural gas export facility this year. The facility will be based in Kitimat, B.C. and will provide Canadian natural gas producers with access to Asian markets. The completion of the LNG Canada facility and the Trans Mountain pipeline will together be instrumental in restoring competitiveness to the Canadian energy sector.

While the recent Trans Mountain and LNG Canada developments are encouraging, Canada's regulatory process with respect to reviewing capital projects remains problematic for prospective business investment.

In a CBC interview in early-May, Imperial Oil CEO Rich Kruger echoed the frustration of many Canadians in describing his company's unpleasant experience dealing with regulators. Citing Imperial's Aspen oil sands project, which was sent to the Alberta Energy Regulator for review in 2013 and is still awaiting approval nearly five years later, Kruger had this to say:

> ***"I have lived and worked in a lot of places, and four-and-a-half years to get a project reviewed that has strong economics and pace-setting environmental performance is inordinately long. This is an illustration of the long, costly, uncertain regulatory environment that the energy industry faces in this country right now." – Imperial Oil CEO Rich Kruger***

Unless the Canadian government can find a way to streamline its regulatory review process for capital projects across all sectors, Canadians will continue to see a departure of capital investment to more favourable business environments. The issue with Canada's regulatory system becomes even more pressing when we consider the current U.S. landscape. Mr. Ouimet points out the fundamental difference between the regulatory environments in the U.S. and Canada:

> ***"For every regulation introduced in the U.S. currently, it's suggested that there are twenty regulations eliminated. If I had to guess, I would say that this ratio is inverted for Canada." – Pierre Ouimet, UBS (Canada) Head Investment Strategist***

IV. Conclusion

If you buckled up as we first suggested in the conclusion of our *2018 Canadian Business Outlook*, it's advised that you remain seated. The outlook for the rest of 2018 remains cloudy, and with cloudiness comes turbulence.

The never-ending standoff that is NAFTA and the jungle gym that is Canada's regulatory system have undoubtedly depressed investment in Canadian businesses over the first quarter. This lingering uncertainty will hamper Canada's economic growth until there is clarity with respect to NAFTA and until the Canadian government takes measures to address regulatory barriers.

U.S. tax reform has boosted liquidity and supercharged M&A activity among American corporate elites, with the first quarter characterized by a bevy of multibillion-dollar deals in the U.S. Meanwhile, cross-border and domestic acquisitions of Canadian targets fell to a post-recession low, likely reflecting the hesitance of investors to tie themselves to Canadian companies amidst a time of such uncertainty.

One cause for optimism is a rebound in the Canadian energy sector, where two significant infrastructure projects are trudging forward and oil prices are rising. LNG Canada and the Trans Mountain pipeline stand to significantly boost the competitive standing of Canada's oil and gas industry if and when they are completed. So, while two projects proceeding may pale in comparison to the efforts of energy-producing competitors around the world, this should be seen as a win for a Canadian economy that has been handcuffed by a string of futile energy infrastructure proposals in recent years.

To wrap it all up, we leave you with Mr. Ouimet's recent remark in a BNN interview, which nicely captures the current state of the Canadian market:

> ***"The Canadian economy is entering choppier waters, with its current state reflecting a struggle between healthy fundamentals and political concerns, most notably trade disputes and regulatory challenges." – Pierre Ouimet, UBS (Canada) Head Investment Strategist***