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INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

LETTER FROM THE PRESIDENT

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Improving business access to public equity capital: The first order of business for recovery

HIGHLIGHTS:

Canadian non-financial corporations have been gorging on debt in recent years, as central banks slashed interest rates and investors piled into corporate bonds. Balance sheets have deteriorated across the corporate sector, reflecting extensive low credit borrowing.

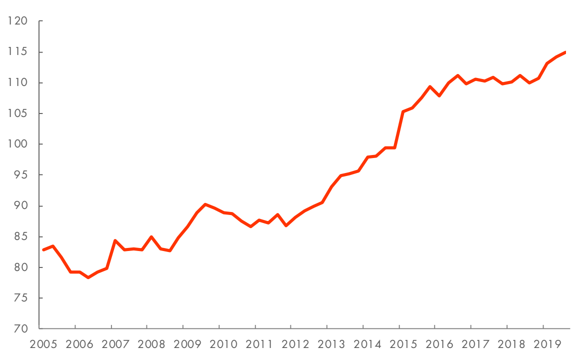
At the height of the COVID-19 crisis, corporate cash flows collapsed and credit markets seized up, forcing policymakers to meet liquidity needs and provide financial support.

Canadian businesses will emerge from the COVID-19 crisis with even more debt, making any economic recovery much harder. Reforms are needed to enable domestic equity markets to tap deeper pools of capital, especially for small business, to strengthen balance sheets and fund investment spending and growth.

Governments are starting to consider the complicated process of lifting the lockdown of the economy and policy options to support recovery. A key concern is the alarming deterioration in the state of corporate balance sheets. Much of the corporate debt build-up occurred in the years following the global financial crisis, chiefly because a low interest rate environment made it easy for companies to borrow, and especially over the past five years driven largely by weak profitability in commodity-related sectors. Small and medium-sized enterprises (SMEs) build-up debt, typically relying on loans and lines of credits from financial institutions and often resorting to credit cards as a source of financing as they found it difficult and costly to go public and raise equity capital. Raising equity capital also became more difficult for SMEs as Canadian institutional investors aggressively turned to exchange traded funds (ETFs) to execute their investment strategies, buying large blocks of stocks (big caps) rather than small-cap offerings. The ageing demographic in retail markets has reduced investment in the riskier shares of small business.

At the end of 2019, private non-financial corporate sector's debt as a share of GDP stood at 115%, the third highest among G20 countries, and a record high level. The COVID-19 crisis most certainly exacerbated the situation. In March, business loans in Canada rose 54% (annualized), according to Bank of Canada data. Total business credit, which includes debt and equity, increased 18% compared to the previous month. With loans now accounting for a greater share of corporate debt, businesses are highly exposed as profits increasingly get squeezed and debt service costs remain at historic high levels, imperiling their ability to repay their debts.

Canadian Non-financial corporate debt as a share of GDP (%)



Source: Bank of International Settlements (BIS).

The non-financial corporate sector also relies heavily on non-bank credit. The amount of bonds outstanding issued by Canadian non-financial firms has more than doubled since the 2007-08 financial crisis, led by firms in the manufacturing, mining, and oil and gas sectors. Before the COVID-19 crisis, an increasing amount of debt issuance was coming from firms that had seen their creditworthiness decline in Canada and were relying on issuing non-investment grade corporate bonds mainly in the U.S., given the limited market for non-investment grade issues in Canada. The share of bonds issued in U.S. dollars by Canadian firms was around 60%. Moreover, an increasing number of Canadian firms were tapping the U.S. leveraged loan market either because they are heavily indebted and/or have weak credit ratings. There is some C$175 billion in outstanding leveraged loans to Canadian non-financial firms, according to the Bank of Canada. Borrowers in these markets are vulnerable to changes in investor sentiment – heightened uncertainty has the potential to destabilize funding as investors run away from riskier debt in times of crisis. This was the case in March when credit spreads widened sharply and the high-yield and leverage loan market seized up as investors took stock to the coronavirus fallout and extreme market volatility.

Carolyn Wilkins, Senior Deputy Governor at the Bank of Canada, noted that "we had understood from our calls with banks that draws on lines of credit were coming at lightning speed, and that their expected loan payment deferrals would add to funding requirements."

Given the prospect of a credit crunch in an environment of ultra-low interest rates, policymakers quickly and decisively acted to support Canadian individuals and businesses facing financial hardship as a result of the pandemic, and to stabilize the financial sector.

- The Bank of Canada reduced its key policy rate to 0.25% and took many steps to improve market functioning, including the implementation of a Government of Canada Bond Purchase Program and a Provincial Bond Purchase Program to support the liquidity and efficiency of this market. Canada's central bank also took steps—for example, it enhanced repo facilities—to ensure financial institutions have ample liquidity to ensure Canadian businesses and households have access to credit. It also started a program to buy banker's acceptances, a key source of financing for many SMEs.

- The Office of the Superintendent of Financial Institutions (OSFI) lowered the Domestic Stability Buffer requirement for domestically systemically important banks thereby releasing an additional $300 billion in lending capacity by major banks to support the supply of credit to businesses and households.
- The government established a new Business Credit Availability Program (BCAP) to provide more than $12 billion in financing (loans at market rates) and other types of support to SMEs with viable business models, whose access to financing would otherwise be restricted, to be used for operational expenses/operational cash flow requirements. The BCAP is being delivered through Export Development Canada (EDC) and the Business Development Bank of Canada (BDC), working with Canadian financial institutions.
- The government also announced the Canada Emergency Business Account (CEBA)—a loan program funded and guaranteed by the federal government and administered by financial institutions. Loans of up to $40,000 are available to small business owners with $20,000 to $1.5 million in payroll, with no interest payable until December 31, 2022 and loan forgiveness of 25% if repaid on or before December 31, 2022.

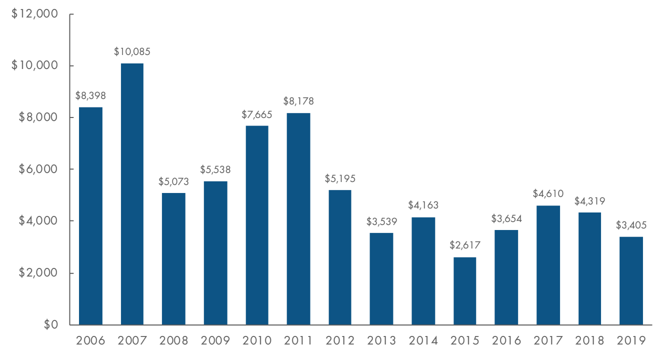
While the active fiscal and monetary responses to the disruptions caused by the pandemic have helped to stabilize the economy and incomes, Canadian businesses will emerge from the COVID-19 crisis with even more debt, making any economic recovery much harder. Some may not even survive. A survey by the Canadian Federation of Independent Business (CFIB) indicates that 40% of small businesses in Canada may not reopen their doors. For other small and large businesses, borrowing will have to be paid down as profits are constrained, forcing companies to scale back or defer capital spending and hiring. A number of companies are at risk of having their credit ratings lowered, and some of the recent issuance of non-investment grade bonds could end up being downgraded, raising borrowing costs and making it more difficult to finance growth and productivity-enhancing investments, and seize evolving business opportunities.

“Structural reforms and monetary policy have promoted the use of corporate bond markets as a viable source of long term funding for non-financial companies since the global financial crisis,” said OECD Secretary-General Angel Gurria. “The high levels of leverage in the corporate sector now make it essential to put in place reforms that make all parts of capital markets fit for purpose. This must include steps to improve the ability of equity markets to strengthen corporate balance sheets and support long-term investments.”

The IIAC could not agree more. It is evident that domestic public equity markets imbed inefficiencies and have limited scope to finance Canadian small business on cost-effective terms. The statistics indicate financings for listed small companies have trended down over the last ten years well below financing levels in the years prior to the 2008 financial crash. An exception was a rebound in small business financings in 2015-18 related to the financing boom in the speculative cannabis sector, as rocketing share prices and price-earnings multiples in newly formed companies, with strong investor demand outstripping existing regulatory costs and inefficiencies to drive up financing activity.

Common Equity Financings (less than $25 million)

Total ($ millions)

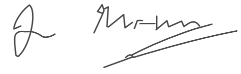


Source: IIROC New Issue Database, IIAC compiled.

As the first order of business, the federal and provincial governments and securities regulators should focus on solutions to help small business obtain better access to public equity markets to strengthen balance sheets and fund spending to expand operations and compete in global markets. The anticipated restructuring of the global business markets into more diversified and reliant supply chains will present opportunities for Canadian business. Canada is well-positioned as an important global location, with a skilled workforce adaptable to evolving new technologies such as AI, good access to many markets in the United States, Europe, and Asia, and the stability of economic and social infrastructure. Private sources of equity capital, venture capital funds and private equity funds, are important, but too small to meet the needs of growing Canadian business. Solutions include the simplification and streamlining of offering documents and disclosure requirements for listed companies; and regulatory relief and mechanisms for small registered dealers intermediating small companies and the investing public to improve access to government-guaranteed subordinated debt for liquidity and capital purposes. The expected June Report of the Ontario Securities Modernization Task Force will identify many regulations and structural proposals to facilitate small business capital-raising. Governments should also consider tax incentives to encourage investor purchases of equity shares of small business, similar to the U.K. Enterprise Investment Scheme (EIS) program, which provides a personal tax credit on share purchasers of eligible small business.

Winston Churchill famously said, “Never let a good crisis go to waste”. This is the time to start thinking outside the box to implement reforms that will strengthen the capital raising ability of businesses in Canada to promote and sustain economic recovery.

Yours sincerely,



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