Canada's Other Debt Problem?

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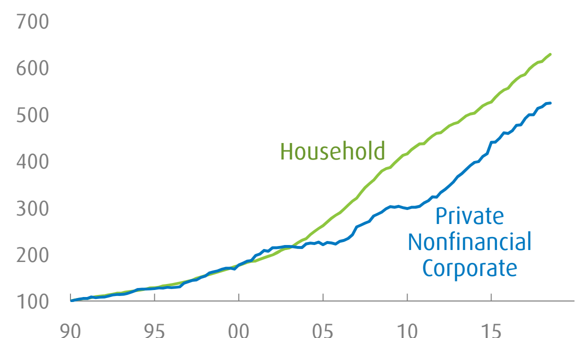
While much ink has been spilled over the rising debt of Canadian households, businesses have drawn far less scrutiny. But if companies are also leveraged to the hilt, the economy will be even more sensitive to interest rate increases and other shocks than we think. Is corporate debt a cause for concern?

Since 1990, private nonfinancial corporate debt has grown more than five-fold to a record $2.3 trillion.[1] It largely kept pace with household debt until the turn of the century, before the latter accelerated (*Chart 1*).[2] Not until the current decade has corporate debt risen rapidly on a sustained basis, averaging 7.5% per annum in the past seven years versus 6.1% since 1990 (*Chart 2*). As a share of GDP, debt grew from 64% in 1990 to 79% in 2011, before leaping to 105% recently. In fact, the debt ratio has risen faster in Canada than in most other countries, though note that international comparisons can be misleading due to differences in measures.[3]

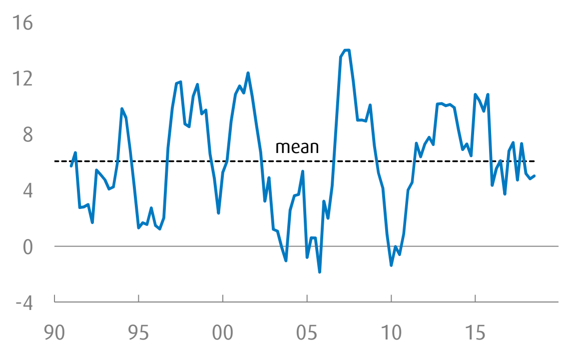
Along with the need to expand capacity, the increase in corporate credit this decade **reflected the historic decline in interest rates**. Business borrowing costs trended down in the past seven years, plumbing record lows by June 2017. In addition, companies borrowed to finance surging condo construction to meet the needs of a growing population. Credit was also used to finance dividend payouts and foreign investments, notably in the pipeline and utilities space. For instance, Canada's Enbridge assumed about US$22 billion of the debt of Houston's Spectra Energy in a takeover deal in early 2017. Foreign direct investment has tracked corporate credit higher, explaining in part why the latter jumped in 2015 despite an oil-led downturn in investment. On the supply end, investors have been only too eager to lend. As in the U.S., high-yield bond issuance grew rapidly in recent years, as lenders traded risk for return.

Chart 1
Till Debt Do Us Part



Sources: BMO Economics, Haver Analytics

Chart 2
Giddy Up



Sources: BMO Economics, Haver Analytics

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[1] Unless otherwise noted, the measure of Canadian corporate credit used in this note is the market value of debt securities and loans (mortgages, non-mortgages and corporate claims, which are loans to affiliated companies) of private nonfinancial corporations. This measure excludes unincorporated business debt, which is included in household debt. The data are published by Statistics Canada in the quarterly National Balance Sheet Accounts. The Bank of Canada also compiles data on corporate credit, though it is less comprehensive (for example, it excludes loans from governments to businesses). The Bank's measure totalled $2.2 trillion in November 2018 compared with Statistics Canada's tally of $2.3 trillion in 2018 Q3. The latter measure has grown slightly faster than the former in the past 27 years (6.1% versus 5.5% per annum), though the growth gap has narrowed this decade. According to Statistics Canada, both data series "*show a similar picture of the indebtedness of Canadian non-financial businesses, currently and in the past*." https://www150.statcan.gc.ca/n1/en/catalogue/13-605-X201800154971.

[2] Household and unincorporated business debt is comprised of consumer loans, mortgages and non-mortgages. It tallied $2.2 trillion in 2018 Q3.

[3] Institute of International Finance. *Global Debt Monitor: Devil in the details*. https://www.iif.com/Portals/0/Files/Global%20Debt%20Monitor_January_vf.pdf January 15, 2019. Chart 1 on page 1 plots the debt-to-GDP ratio of global non-financial corporations. The increase this decade is much slower than in Canada.

However, **in the past year corporate debt growth has slowed** to 5.0% in response to higher interest rates and a slower economy.[4] Capital-intensive industries, such as resources, agriculture, and transportation, are particularly vulnerable to higher borrowing costs. A further downshift in credit growth is expected due to lower oil prices, which the Bank of Canada believes could lead to a 12% reduction in energy-sector capital spending this year. High office vacancy rates in Calgary and Edmonton will also depress commercial lending long after crude prices have recovered. Providing a partial offset will be the accelerated depreciation allowance, assumed ratification of the USMCA by the U.S. Congress, and very tight office and industrial markets in Toronto and Vancouver.

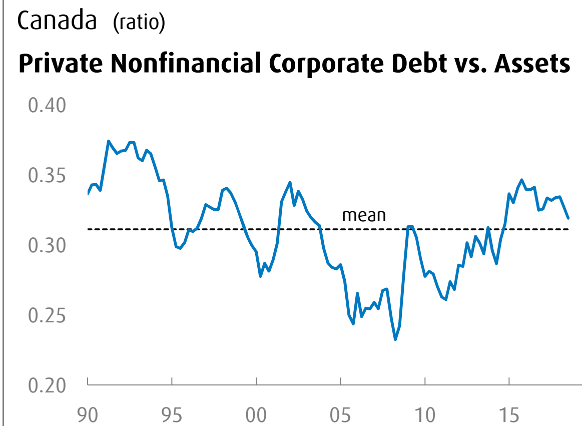
While corporate debt grew rapidly this decade, so too has the other side of the balance sheet. The ratio of debt to assets stood at 0.32 in 2018Q3, close to the long-run norm (*Chart 3*). Although businesses have mostly borrowed to buy assets, one concern is that more credit went into financing the purchase of securities rather than productive assets, like machinery and buildings (*Chart 4*). Of course, this also implies some room to sell securities to repay debt.

Corporate debt is not high compared with profits (*Chart 5*). The current ratio is just modestly above the two-decade mean and well below peaks reached in the last recession and oil-price downturns of 1998 and 2015.

Most companies should have little difficulty juggling a moderate increase in interest rates.[5] To be fair, Canadian firms have the fourth highest debt-service ratio among 32 countries.[6] And, interest payments by nonfinancial corporations have almost doubled in the past seven years. However, payments are down from a year ago and remain low relative to assets, at 1.3% in 2018Q3 versus a long-run mean of 1.5%. They also consume a normal share of operating revenue (2.0% in Q3) and operating profits (25.8%). This means most companies are generating sufficient cash to service debt, and should have little trouble doing so provided the economy stays reasonably healthy.

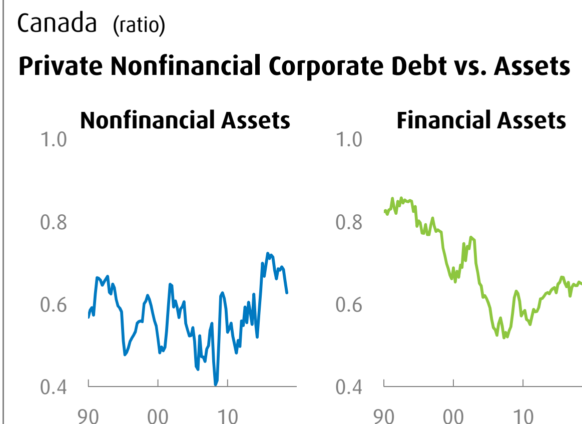
One possible exception is the oil industry, where interest payments gobbled up 6.2% of operating revenue in Q3, above the long-run

Chart 3
Tracking Assets



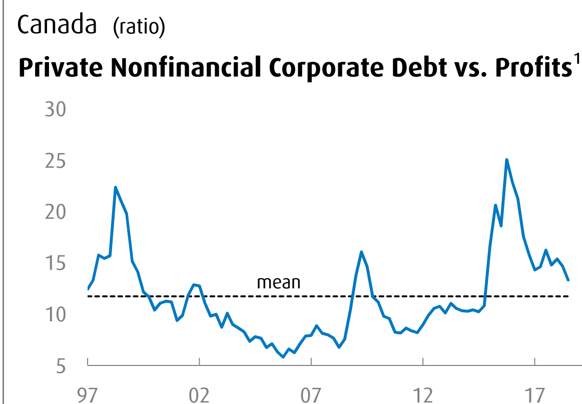
Sources: BMO Economics, Haver Analytics

Chart 4
Buying Security



Sources: BMO Economics, Haver Analytics

Chart 5
Ample Coverage



Sources: BMO Economics, Haver Analytics
[1] Nonfinancial corporate after-tax profits (s.a.a.r.)

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[4] Bank of Canada corporate credit data show a moderation in growth to 5.9% y/y in November from the seven-year average of 7.2%, with continued double-digit gains in loans (11.7%) offset by slower issuance. Household debt has decelerated even faster to the slowest rate (3.2% y/y in November) since 1983.

[5] We expect the Bank of Canada to lift policy rates another 50 basis points this cycle to a still-historically low 2.25%.

[6] BIS. https://stats.bis.org/statx/srs/table/g1 Note that other capital-intensive resource-producing countries, such as Australia and Norway, also have high corporate debt-service ratios.

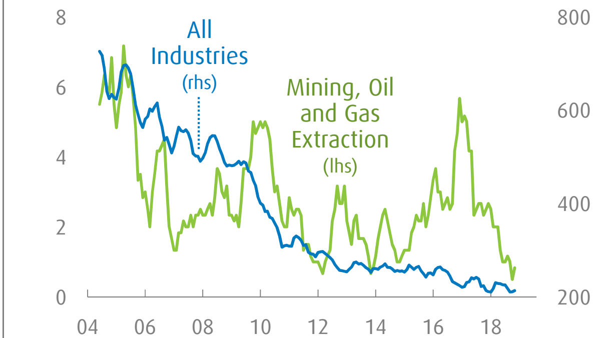
norm of 5.5%, and that's before the recent drop in prices. Still, the massive oil sands investments of the past two decades required a large amount of credit, but now that those projects are completed, they are cash-flow positive, even with relatively low oil prices as operating costs are also very low.

To date, there is little sign of financial strain, with **business bankruptcies near record lows**, even accounting for the long-term structural decline (*Chart 6*). Bankruptcies remain low in the energy patch, too, after spiking in 2016.

Bottom Line: The increase in Canadian business debt is worth monitoring but is not a cause for alarm. Moderately high debt levels may leave less room for firms to invest, while increasing the economy's sensitivity to higher interest rates. Still, corporate debt is not high relative to assets or profits, while interest coverage appears adequate. Companies took advantage of unusually low credit costs this decade to grow assets (and dividends), which will be used to service debt in the wake of more normal, though still-low, borrowing costs.

Chart 6

Piper Paid



Sources: BMO Economics, Haver Analytics

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