REPORT

Canada debt market: Q1 2023

The Canadian debt market has been on the tighter side of normal amid a period of economic headwinds. Given rising interest rates and increasing inflationary pressures, investors and policymakers alike are closely monitoring the performance of the Canadian debt market. With this report, our M&A and Capital Markets/Capital Advisory teams aim to provide an overview of the current state of the Canadian debt market, highlighting key trends, challenges, and opportunities for investors.

Canadian lending overview

Despite market challenges, the Canadian debt market experienced growth in Q1 of 2023. However, the growth was slower in comparison to the prior two years. Year-to-date loan issuance was $1.28 trillion, a 9% increase over the prior year. This was primarily driven by demand for new money. Real estate (30%) and financial services (15%) made up the bulk of total lending in Canada, followed by wholesale and retail trade (10%), and services (10%). These four areas made up 65% of total business lending in Canada.

Canadian lending growth moderated at 1% in Q1 vs. the fourth quarter of 2022. This was a modest increase compared to 2022 when lending growth increased 8% per quarter. Overall, the first quarter of 2023 saw a levelling effect in lending growth and a return to normal compared to the frenzied pace of lending in 2021 and early 2022.

The Bank of Canada reversed its stimulatory policy stance and oversaw a series of interest rate hikes to manage inflationary pressures. This resulted in a more conservative lending environment in Canada. Due to these factors and market uncertainty, financial institutions in Canada maintained more discipline in underwriting and structuring. The funding and close timelines for lending transactions was also extended. This reduced risk appetite impacted higher risk deals and muted the pace of lending.

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Domestic banks continued to be the largest business credit provider. However, alternative lenders provided substantial credit to businesses looking for capital outside traditional lenders. In Q1 of the $1.28 trillion loaned, 60% was from domestic banks and 40% was from alternative lenders. As the lending markets compressed, alternative lenders continued to fill the gap as they saw the slowdown in activity by the big Canadian banks as an opportunity to deploy capital. American alternative debt providers, including private equity firms, continued to be active in Canada.

Looking forward, larger financial institutions in Canada will continue to look for opportunities to grow their loan portfolios, but their focus will be towards higher quality assets.

Canadian M&A overview

Against this backdrop, there was a reduction in M&A activity in Q1 as many deal closings were delayed amid financing challenges. However, this was a reset back to normal after Canadian M&A experienced record deal volumes in 2021 and 2022.

However, M&A activity continues to be higher than pre-pandemic levels. In 2022, there were about 2,000 M&A transactions worth a total value of $196 billion, compared to $133 billion in 2019. Additionally, private equity experienced strong deal volumes in 2022. In Q4 of 2022, $2.3 billion was invested across 194 PE deals, and $10 billion was invested across 890 deals for the year.

Globally, there is US$3.4 trillion in dry powder. We expect to see an increase in private equity activity as buyers take advantage of adjusted valuations. Well-capitalized companies are making acquisitions in their core businesses, which will drive acquisition activity in 2023 despite economic uncertainty.

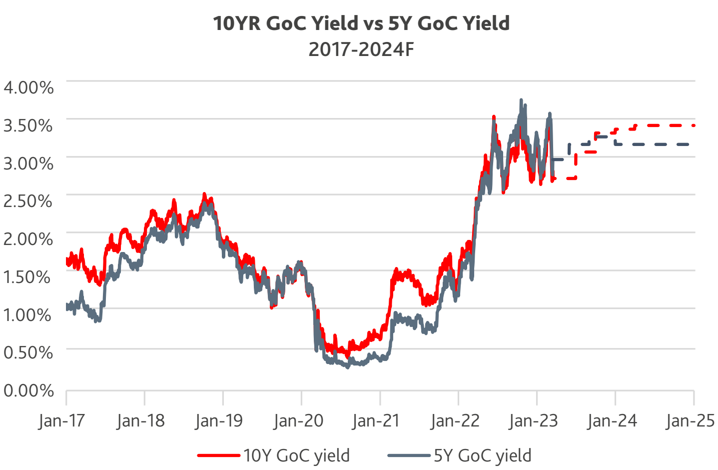
However, as part of the reset in the M&A market there is and will be a focus from buyers on quality deals. Buyers will look for well-run companies with strong management teams. They will continue to focus on businesses that add synergies and businesses that provide supply chain optimization.

Market dynamics and recent events

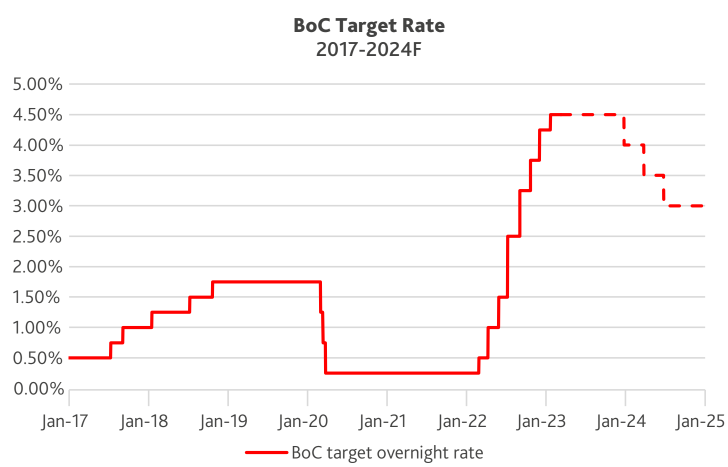
On March 10, Silicon Valley Bank (SVB) collapsed and was taken over by federal regulators, making it one of the largest American bank failures since Washington Mutual in 2008. This occurred primarily due to fundamental mismanagement issues and a lack of interest rate risk management at SVB. Specifically, there was no third-party monitoring of SVB's interest rate risk management. Given the smaller loan book of SVB in Canada and the conservative Canadian regulatory regime, impact of the SVB collapse will be muted in Canada

The global banking sector continues to undergo changes after Swiss authorities worked with UBS to facilitate the purchase of Credit Suisse. The U.S. Federal Reserve Board created a funding program to help ensure that banks have the ability to meet the needs of all depositors following the collapse of both SVB and Signature Bank. Given government intervention, these events are isolated and do not indicate any systemic risk.

To control inflation, central banks have hiked rates significantly over the last year. They must now consider the impact of the rate hikes on the stability of the global economy. This could lead central banks to pause rate hikes in the near term as inflation eases and economies slow.



Source: Bank of Canada; BDO analysis



Source: Bank of Canada; BDO analysis

Leverage ratios

Canadian Banks: Senior Debt/EBITDA			
	< $5M	> $10M	> $20M
Jan 2023	1.75x - 2.75x	3.00x - 4.00x	3.50x - 4.00x
Feb 2023	1.75x - 2.75x	3.00x - 4.00x	3.50x - 4.00x
Mar 2023	1.75x - 2.75x	3.00x - 4.00x	3.50x - 4.00x

Source: BDO, M&A and Capital Markets estimates

Alternative Lenders: Total Debt/EBITDA			
	< $5M	> $10M	> $20M
Jan 2023	3.00x - 4.00x	4.00x - 4.75x	4.25x - 5.00x
Feb 2023	3.00x - 4.00x	4.00x - 4.75x	4.25x - 5.00x
Mar 2023	3.00x - 4.00x	4.00x - 4.75x	4.25x - 5.00x

Source: BDO, M&A and Capital Markets estimates

Canadian Banks: Senior Debt Pricing			
	< $5M	>$10M	> $20M
Jan 2023	C+2.0% - 3.5%	C+2.0% - 3.0%	C+2.0% - 3.0%
Feb 2023	C+2.5% - 3.5%	C+2.0% - 3.0%	C+2.0% - 3.0%
Mar 2023	C+2.5% - 3.5%	C+2.5% - 3.5%	C+2.5% - 3.5%

Source: BDO, M&A and Capital Markets estimates

Alternative Lenders: Pricing			
	< $5M	> $10M	> $20M
Jan 2023	10% - 15%	8% - 12%	8% - 12%
Feb 2023	11% - 15%	9% - 12%	9% - 12%
Mar 2023	11% - 15%	9% - 12%	9% - 12%

Source: BDO, M&A and Capital Markets estimates

M&A and Capital Markets overview

Our M&A and Capital Markets advisory professionals have the knowledge, network, and experience to help mid-market companies navigate these issues and other factors affecting their business. Through a holistic approach that never loses sight of the big picture, we offer many service lines for our clients, including merger and acquisition services.

Capital Advisory overview

Our Capital Advisory team works with companies to find the right capital solution for their business. We have relationships with commercial banks, alternative lenders, private equity firms, and other capital/debt financing providers in Canada, the United States, and globally, which allows us to find financing that aligns with client objectives.

Our team offers a client-centric approach to capital raises, which includes:

- Financing solutions
- Debt advisory
- Integrated project finance and infrastructure financing
- Private equity support

To learn how BDO Canada's M&A and Capital Markets/Capital Advisory teams can help, please contact us.

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