Canada debt market report: Q2 2023

The Canadian debt market experienced moderate growth in the second quarter of 2023 due to high interest rates and economic uncertainty. Canadian banks continued to maintain a cautious approach toward lending.

In this report, our Capital Advisory team aims to provide an overview of the current state of the Canadian debt market, highlighting key trends, challenges, and opportunities for investors.

Canadian lending overview

The Canadian debt market experienced moderate growth in Q2 of 2023, but the growth was slower in comparison to the prior two years.

Year-to-date loan issuance was $1.3 trillion, driven primarily by the demand for new money. Loan issuance increased by 10% over the prior year. The real estate (9.4%) and services sectors (15.4%) made up the bulk of total lending in Canada, followed by the manufacturing (20.8%) and retail and wholesale sectors (10.8%). These four areas made up almost 60% of total business lending in Canada.

The slower pace of lending in Q2 2023 was mostly driven by a more conservative risk appetite at large Canadian institutions. Banks are being more prudent given current economic uncertainty. Slower loan growth was evident across all industries, with an especially measured pace of lending in the financial services industry due to an increase in provisions for credit losses (PCL) and rising funding costs as a result of higher interest rates.

Lending from banks

Canadian bank funding is becoming scarcer and more expensive. Compared to their international peers, Canadian banks rely heavily on wholesale funding and less on deposits to fund their balance sheets. This greater reliance on wholesale funding reflects the fact that Canadian banks keep a larger share of loans and mortgages on their balance sheets than U.S. banks.

In the second quarter of 2023, lending growth from Canadian banks reduced to 5% on a quarter-over-quarter basis, compared to 8.3% on average in 2022 and 2021. The current increase in the cost of bank funding is a normal transition to a higher interest rate environment.

In a press release on July 11, 2023, Laurentian Bank announced that it's reviewing its future strategic options to maximize shareholder and stakeholder value. There are reports that Laurentian Bank is potentially considering a sale. This has raised questions about the stability of the Canadian banking sector. However, since the large Canadian banks are highly regulated with a diversified customer base, they are stable. In addition, stress testing conducted on rising rates has performed well so far.

Alternative lending

Of the $1.3 trillion loaned in Q2 2023, 60% was from Canadian banks and 40% from alternative lenders and private debt funds, according to Statistics Canada. U.S. alternative lenders continued to be active in the Canadian market.

With alternative debt readily available in Canada, there are options for companies in distress or those outside the banks' risk appetite.

Commercial real estate

The commercial real estate and construction sector continued to be the largest recipient of financing with both banks and alternative lenders. This sector continued to outperform expectations, despite market headwinds and overall economic uncertainty.

Industrial real estate continued to grow, driven by demand in distribution and warehousing. Real estate investment trusts (REITs) slowly ventured back into the market, with a rising need for multi-family housing. Land sales continued to remain high despite higher borrowing costs, demonstrating the continuing strength of the construction sector. Vendor take-back mortgages re-emerged in several markets as sellers worked with buyers to close the deal.

Retail continued to be surprisingly robust. Brick-and-mortar storefronts are resonating with consumers, despite a rise in online activity.

The one area that continued to struggle is office space, with hybrid work models being implemented by more and more businesses. Repurposing commercial office space to residential in major Canadian centres is the key to healthy, vibrant downtown cores.

Mid-market businesses continue to outperform

The bright light in the economy were mid-market businesses, which continued to outperform expectations. The balance sheets of these businesses are healthy, corporate indebtedness is low, and cash balances remain high. In fact, the leverage of these businesses is below pre-pandemic levels and liquidity is at an all-time high.

Rising rates with a path to recovery

Given the strength of the economy and stick inflation, the Bank of Canada announced a rate hike of 25 basis points on July 12, taking the overnight rate to 5%. We anticipate one more rate hike in 2023.

However, with ongoing healthy consumer spending, continued high employment, and the strong performance of mid-market businesses, a recovery is likely to occur in the early part of 2024.

The key to recovery in 2024 will be continued access to financing. Large corporate and mid-market businesses will need to focus on liquidity, cash flow forecasting, and demonstrating strong balance sheets. All businesses must have processes in place to ensure the timely collection of outstanding receivables.

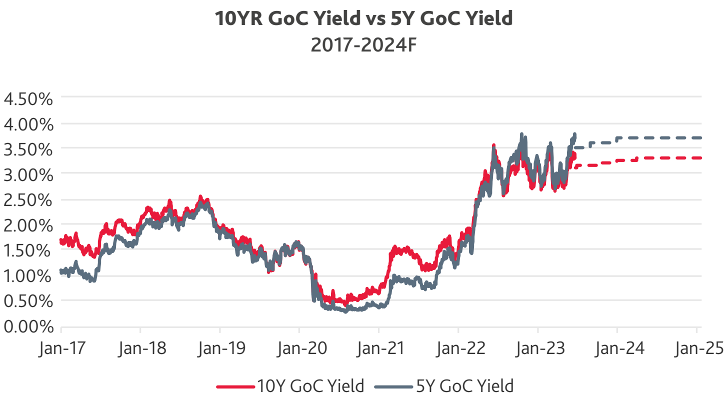
Businesses should also look at their level of risk related to cash management, conduct regular risk assessments, and address any gaps. Financing providers are looking at businesses' ability to have contingency plans in place. Banks' lending volumes are expected to stay moderate during the remainder of fiscal year 2023, with the big six Canadian banks positioned with tighter, yet adequate, levels of liquidity and capital.

ESG and access to capital

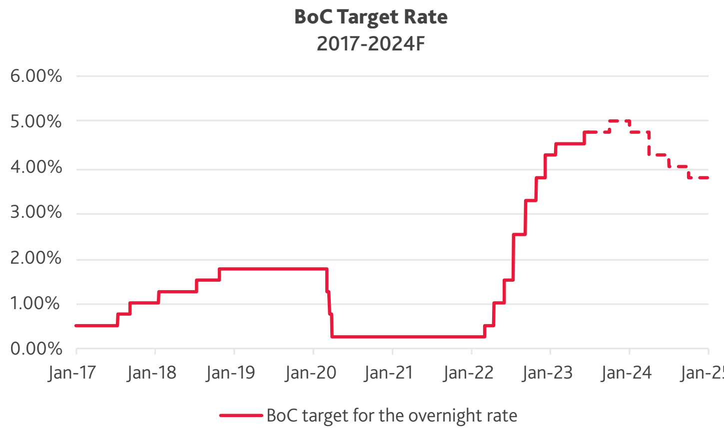
The environmental, social, and governance (ESG) movement is shifting investor expectations and disrupting private investment criteria. Banks and private equity firms are now paying closer attention to their future investments and are making decisions based on their portfolio companies' ESG risk profiles. The focus by financing providers is increasingly shifting from whether businesses have integrated ESG to where and how they've implemented it. Capital providers are now committed to greenhouse gas (GHG) reduction.

A well-developed and executed ESG strategy can act as a pillar of value creation for organizations and can lead to stronger financing terms, conditions, and rates.
Organizations operating in carbon-intensive industries that have fully integrated ESG into their business strategy will have a greater ability to access capital and can generate higher asset valuations and price-to-earnings (P/E) ratios of their stocks.

Leading banks around the world have signed the Net-Zero Banking Alliance, a global group of banks committed to aligning their lending and investment portfolios with net-zero emissions by 2050. Similarly, private equity firms are also starting to incorporate ESG issues into their investment analysis and decision-making process. Organizations that start to incorporate various ESG elements into their operations and long-term business planning can enhance their competitiveness in the market.



Source: Bank of Canada; BDO analysis



Source: Bank of Canada; BDO analysis

Leverage ratios and debt pricing

Canadian Banks: Senior Debt/EBITDA			
	< $5M	> $10M	> $20M
Apr-23	1.75x - 2.75x	3.00x - 4.00x	3.50x - 4.00x
May-23	1.75x - 2.75x	3.00x - 4.00x	3.50x - 4.00x
Jun-23	1.75x - 2.75x	3.00x - 4.00x	3.50x - 4.00x

Source: BDO, M&A and Capital Markets estimates

Canadian Banks: Senior Debt Pricing			
	< $5M	>$10M	> $20M
Apr-23	C+2.5% - 4.0%	C+2.5% - 3.5%	C+2.5% - 3.5%
May-23	C+3.0% - 4.0%	C+2.5% - 3.5%	C+2.5% - 3.5%
Jun-23	C+2.5% - 3.5%	C+3.0% - 4.0%	C+3.0% - 4.0%

Source: BDO, M&A and Capital Markets estimates

Alternative Lenders: Total Debt/EBITDA			
	< $5M	> $10M	> $20M
Apr-23	3.00x - 4.00x	4.00x - 4.75x	4.25x - 5.00x
May-23	3.00x - 4.00x	4.00x - 4.75x	4.25x - 5.00x
Jun-23	3.00x - 4.00x	4.00x - 4.75x	4.25x - 5.00x

Source: BDO, M&A and Capital Markets estimates

Alternative Lenders: Pricing			
	< $5M	> $10M	> $20M
Apr-23	11% - 15%	10% - 15%	10% - 12%
May-23	11% - 15%	10% - 15%	10% - 12%
Jun-23	11% - 15%	10% - 15%	10% - 12%

Source: BDO, M&A and Capital Markets estimates

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

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.

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

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Our people-first approach to our talent experience has earned us multiple awards, including a spot among Canada's Top 100 Employers for 2023.

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