Québec businesses seem solid

Consumers’ financial situation has been the focus of attention recently. However, there seems to be less concern about the situation for business. At first glance, they seem to be in good health: profits are at fairly comfortable levels, business debt levels are at a low and they have a lot of liquidity on hand. Low interest rates have also brought borrowing costs down, making the number of bankruptcies decline. This Economic Viewpoint will look at a number of financial indicators for business in order to take Québec’s pulse. To provide for greater depth, we will also review the statistics for a few activity sectors. We will pay special attention to manufacturing, which has been undergoing a number of structural changes in recent years. This will make it possible to establish how well businesses will be able to cope with the current uncertainty and continue to support economic growth, particularly through investments.

THERE ARE PROFITS

Corporate earnings before tax are a good barometer of financial health. However, profits depend on a number of factors that are specific to corporate operations, such as production costs, including labour costs, business volumes and sale prices. Movement by profits is also closely linked to economic cycles (graph 1). During the severe recessions in the early 80s and 90s, corporate earnings plunged by 46.0% and 56.2% from the cycle’s peak to its trough. Note that real GDP contracted sharply at that time with the contraction lasting several consecutive quarters. Moreover, debt rates and borrowing costs were very high, with a heavy impact on corporate profitability. Subsequently, profits underwent a few short weak periods, especially during the economic slowdowns in 1995 and the early part of the new millennium. However, the 2008-2009 recession left its mark, with corporate pre-tax earnings tumbling 27.7% over the course of three quarters.

Since the cyclical trough in mid-2009, Québec profits are up by about 35%. Although they seem to have flagged since the spring of 2011 and we could see a slight correction in the next few quarters, the situation should remain relatively favourable. The leading indicator of corporate profits published by the Conference Board of Canada has also been showing a slight downtrend for the last four months. However, the monthly dip is small, a situation that does not point to any major tumble by Canada’s corporate profits in the coming months, indicating instead a slight adjustment by the end of 2011, followed by some stagnation in early 2012.

Historically, in assessing the relative level of corporate profits, we need to consider the size of the economy. Since 1981, Québec’s ratio of pre-tax profits to nominal GDP has been an average of 8%. It fell well below this in the early 80s and 90s, dropping just below the average during the last recession.
The 2008-2009 real GDP contraction thus had only a small impact on profits (graph 2). The current ratio, which is in line with the historic average of 8%, confirms that corporate profits are fairly healthy, at least overall.

**HIGH OPERATING MARGINS**

Businesses’ financial soundness is also tied to profit margins. The ratio between earnings and operating income determines which percentage of the company’s earnings are profits. In Canada, operating margins are historically high (graph 3). In the last 20 years or so, there have been three weak periods, i.e. during the 1990-1991 recession, the 1995 slowdown, and the 2001 slowdown. For business, the financial situation deteriorated, as shown by the fact that the profit margin dropped below its historic average. In the third quarter of 2011, the 6.8% ratio was comfortably above this level, reflecting a fairly sound situation for all of the country’s non-financial industries. For the last several years, Canadian small business operating margins have been fairly close to the overall ratio. It thus seems that businesses are on a firm footing, regardless of size.

The annual data available for Québec (1999 to 2009) show that movement by profits is fairly similar to Canada’s (graph 4), although the level is slightly higher. The early part of the last decade saw some weakening, followed by a comeback. The latest picture for Québec is thus fairly similar to Canada’s, with fairly attractive profit margins.

**ABUNDANT LIQUIDITY**

In a situation in which the Québec non-financial industry’s profits and profit margins are comfortable, it is not surprising to see strong liquidity. The cash holdings to assets ratio even reached a 10-year peak after plunging during the economic slowdown in the early 2000s (graph 5). Businesses thus have a lot of cash for securing growth, particularly through hiring, investment or mergers and acquisitions. The current climate of uncertainty could delay some decisions, prompting businesses to amass cash rather than using it to expand or finance new projects. One thing is certain: the abundant liquidity gives Québec businesses some financial leeway, making it easier for them to get through the current turbulence.
VERY LOW DEBT RATES ...
Aside from profits, profit margins and the liquidity ratio, the debt rate helps establish whether a business is in shaky financial health. The more a company turns to borrowing, the more sensitive it is to interest rate movements. The debt ratio of non-financial industries is at an almost historic low in Canada (graph 6). This indicator is not published for Québec, but the findings are probably fairly similar.

Why is the business debt rate so low? “This ratio declines when a company uses its own equity – retained earnings and net share issues – rather than relying on borrowed funds to finance growth1.” According to a study from Statistics Canada2, the structural decline by the debt rate steepened as of 2003, when business earnings shot up. After that, net capital stock issues also brought the debt rate down. Decreased borrowing due to the use of other sources of capital means that businesses are not very vulnerable to an upswing by interest rates. In any event, it seems like a distant threat for now. The persisting global economic and financial uncertainty will help keep interest rates low for several more quarters, making the spectre of higher borrowing costs more remote. Given businesses’ very solid balance sheets, the risks here are low and, in particular, remote. In this context, bankruptcies should remain low (see box 1 on page 4).

... AND FINANCING COSTS
A greater proportion of capital needs are thus being met with industries’ internal financial resources, reducing recourse to loans from financial institutions. Aside from conventional loans, some corporations are issuing bonds or stock to gain access to capital. Major corporations can issue corporate bonds to fill their coffers; if listed on the stock exchange, corporations can issue stock.

In Canada and Québec, very few businesses have the capacity to issue bonds to diversify their financing sources. In 2011, about one-third of issues were made by non-financial firms. These are frequently major international corporations whose reputations have been made. The interest rate associated with issuing a series of bonds depends on the credit rating assigned to the corporation by rating agencies such as Moody’s, Standard and Poor’s, DBRS and Fitch. Ten-year corporate rates are currently historically low (graph 7), and well below where they were during the 2008-2009 financial crisis. Yields on bonds with higher credit ratings are generally lower and, in particular, more stable than lower quality bonds, because investors demand a risk premium. Bond yield fluctuations differ depending on the quality of the securities, as eloquently shown by the substantial widening of yield spreads at the end of the last decade. However, remember that, overall, bond yields are historically low, giving major corporations access to low-cost capital.

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For businesses that issue stock to top up their capital, the current context is not necessarily very conducive, due to the weak stock market. Movement by the Québec-30 stock index, compiled based on the 30 largest corporations headquartered in the province and whose stocks are listed on a North American exchange, gives us a good overview of this item of corporate financial leverage. The value of Québec companies’ securities has been shaken since the end of the summer as the European sovereign debt crisis broke out and Standard and Poor’s downgraded U.S. debt. The damage is not as extensive as it was during the 2008-2009 financial crisis (graph 8), but another wave of depreciation cannot be ruled out until we have put the economic and financial uncertainty behind us. In this context, the stock market may not give businesses access to all of the capital they want.

BOX 1

**BANKRUPTCIES ARE FREEFALLING**

Corporations’ good financial situations are having a positive impact on bankruptcy statistics. In 2010, the number of bankruptcies hit a historic low (graph A) and the number of businesses that had to make proposals to their creditors to break an impasse remained fairly stable. Consequently, about 2,000 businesses, or 0.5%, were considered insolvent in Québec in 2009 (graph B). A number of factors are behind the downtrend: high profit levels and operating profit margins, abundant liquidity, the drop in the debt rate and, of course, the substantial decline by interest rates in the last few years.

In fact, the substantial drop in borrowing costs had a positive domino effect on most industry financial indicators. Lower interest rates have helped reduce this type of spending, resulting in higher profits and greater liquidity. The prime business interest rate is currently around 3%. This level, close to the historic low of 2.25% reached during the 2008-2009 recession, is helping ease the financial burden carried by companies with debt, thus reducing the number of bankruptcies. This interest rate hit a peak of 20% in 1981 and closed in on 15% in 1991 (graph C). At the time, an explosive combination of high debt rates and borrowing costs that many businesses found tough to carry dealt a harsh blow to their profitability, forcing many of them to table their balance sheets and seek protection under the Bankruptcy Act. After tumbling 20% in 2010, business bankruptcies should stabilize around 1,600 this year in Québec.

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FLEXIBLE CREDIT CONDITIONS

Aside from the interest rates set by financial institutions, broad credit conditions, i.e. the rate and non-rate conditions for lending, affect businesses’ borrowing capacity. The Bank of Canada’s quarterly survey helps us reach some conclusions here. The balance of opinion indicates whether financial institutions’ credit conditions are tightening or easing, but does not provide any indication of the level. For example, conditions tightened somewhat during the 2008-2009 financial crisis (graph 9), limiting credit. As small businesses usually have less collateral and a shorter credit history than larger businesses, access to financing is sometimes tougher for them, as occurred in the last recession.

The balance of opinion on credit practices shows that the standards for lending eased for all borrower categories during Q3 of 2011. “For corporate borrowers, lending conditions eased for the ninth straight quarter. For commercial borrowers, the survey results indicate a net easing for the sixth consecutive quarter, while for small businesses, overall lending conditions improved for the fourth quarter in a row. The balance of opinion regarding the demand for credit from businesses increased during the third quarter. This net increase was mostly related to a rise in demand for financing for general purposes.”3 The upheaval that has been characterizing the financial markets since the end of summer 2011 has not kept lenders from easing their rules on lending to business.

Despite the global economic and financial uncertainty, lending to business is up in Canada from the spring of 2010, with the pace of growth even slightly higher than the average for the last 20 years (graph 10). The fact that industry’s demand for financing is so strong is because the current context does not, at least for now, appear to have curtailed their expansion or modernization plans. Even though credit to business continues to rise, the debt levels of non-financial firms remains at a low, so the situation is not a concern.

INVESTMENT ON THE RISE

The Canadian and Québec economies’ current expansion cycle is largely based on business investment. Business confidence must remain strong for the turnaround that started at the end of 2009 to continue. In Canada, the Conference Board index has declined in recent quarters due to the uncertainty in global markets. Still, business confidence is at its historic average, usually consistent with some growth by investment. The barometer of small and mid-sized businesses allows us to take the pulse of business provincially, particularly for Québec. According to the Canadian Federation of Independent Business, SMB confidence fell for a third straight month in October 2011, although it did not plunge as far as it did during the 2008-2009 recession (graph 11). The fact that business leader sentiment has been shaken by the global context could

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make them cautious about their investment plans. For now, the uptrend seems to be holding. Businesses once again increased their investments in non-residential buildings in the third quarter, particularly in the commercial sector. It thus seems that business confidence has not eroded enough to compromise the ongoing upswing by investment. The fact that non-financial businesses are not carrying much debt overall and that profits are respectable give them some leeway for investing.

THE FINANCIAL SITUATION IS NOT AS FAVOURABLE IN SOME SECTORS

There are major differences among the sectors. Frequently, profit evolution depends on whether industries are operating at close to their maximum output capacity. If activity is too slow, business volumes are generally too low to secure profitability and sometimes even the company’s survival. If plants are operating at close to full tilt, profits are higher and they are in a more comfortable financial situation. The industrial capacity utilization rate\(^4\), available for Canada as a whole, determines how intensely facilities are being utilized. In the second quarter of 2011, industries were operating at 78.4% of capacity, close to their historic average, about 80% (graph 12). Business profits are thus relatively high, even though they are not yet at pre-recession levels.

While the recession gave manufacturing industries a beating, the situation has improved somewhat since then. Canadian manufacturers are, overall, operating at close to 80% of production capacity and pre-tax profits have returned to pre-recession levels (graph 13). However, the utilization rate varies substantially from industry to industry. For example, manufacturers of computer and electronic products were operating at 97% of capacity in Q2 2011, while other sectors, such as the beverage and printing sectors, were under 70% of capacity (graph 14). These differences reflect major disparities in industries’ financial situations, as shown by the disparity in profit margins.

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\(^4\) Includes forestry, mining, oil and gas extraction, construction, manufacturing and utilities.
MANUFACTURING SECTOR NOT AS SOUND

Some Québec indicators show that manufacturers’ balance sheets are not as good as they are for all industries. On one hand, profit margins have eroded substantially in the last 10 years (graph 15), coinciding with the Canadian dollar’s rise. In 1999, the loonie was below US$0.70, and then climbed close to US$0.90 on average 10 years later. The smaller operating margins attest to the erosion of manufacturers’ financial situation. The decline by the liquidity ratio is another worrisome sign for manufacturers (graph 16), especially as the gap with all non-financial industries has widened substantially in the last 10 years in Québec. The problems in forestry, as well as pulp and paper, along with the rationalization of the textile and clothing sectors, have helped worsen the balance sheets of all manufacturing industries. Major structural changes have made their mark over the years. Given that the loonie is now close to parity, the situation could remain tough for manufacturers. Of all of Canada’s activity sectors, manufacturing is recording one of the highest bankruptcy rates (graph 17).

CONCLUSION

In short, in Québec, businesses seem to be in a good enough financial situation to get through the current period of uncertainty without too much trouble. Profits and profit margins for all industries are relatively high, pointing to good profitability for both small and big business. The abundant liquidity and low debt rates and financing costs sharply decrease businesses’ financial vulnerability. The number of bankruptcies has also tumbled over the last several years, in line with the drop in interest rates, among other things. The picture is not as good for the manufacturing sector, however, where profit margins are shrinking. This sector must also cope with less liquidity. It is not surprising that the bankruptcy rate is this high for manufacturers.

Overall, businesses are financially sound in Québec, which should allow investment to remain on the rise for the coming quarters. Business confidence has naturally been shaken by the global context, but not enough to neutralize its contribution to economic growth. The current context remains uncertain, as Europe is on the verge of recession and the shaky banking system could prompt another wave of contagion in global financial markets. Even though the situation for business remains relatively sound in Québec, businesses are not safe from a major financial crisis that would generate major deterioration by the economic situation.