Canada debt market report

Q4 2023

Reflecting on Q4 2023, the Canadian debt market continues to signal caution amid economic uncertainties. Evolving lending trends and persistent inflationary pressures underscore the need for strategic financial management.

This report sheds light on key trends and challenges encountered during the fourth quarter of 2023, exploring the factors shaping its trajectory and offering insights into strategic approaches for businesses in the year ahead.

Key highlights

The Canadian debt market continued to experience slow overall growth in Q4 2023. Year-to-date loan issuance was C$1.43 trillion, driven primarily by the demand for new money, whereas loan issuance increased by 5% over the prior year. This was significantly reduced as compared to the 9% year-over-year loan growth in 2022.

The real estate and financial services sectors made up the bulk of total lending in Canada, followed by the retail and wholesale, as well as other professional services sectors. These four areas comprised almost 60% of total business lending in Canada.

The economy continues to defy logic: Where is the recession?

2023 saw the implementation of the steepest series of interest rate hike increases in decades. This led to increased housing costs and elevated consumer prices with retail activity slowing down significantly in 2023, primarily driven by a decrease in discretionary spending. Residential and commercial construction slowed with new builds pulling back. Despite these pressures, the economy continued to defy logic and avoided recession.

The fourth quarter, notably December, saw a brisk decline in bond yields across the curve which erased 12 months of yield increases driven by an anticipated reduction in rates by the Bank of Canada (BoC).

Although the yield curve remained inverted in Q4 2023, this quarter saw a significant repricing of the Canadian yield curve as markets took the increasingly dovish central bank narrative as a pivot they had been waiting for a rate reduction. In response, bond yields dropped by around 100 basis points for all tenors beyond the front end of the yield curve in Q4 2023.

Revenue growth continued for enterprise and mid-market businesses despite challenging conditions. Businesses were able to find labour as labour markets continued to cool with employment being a steady 5.8% in December 2023 vs. 5.2% in December 2022. Conversely, most businesses broke their streak of rising margins against all odds and experienced a reduction in their net income and the almighty EBITDA. This was driven by higher input and borrowing costs.

Canadian banking landscape: Banks offering support during uncertainty

During the Covid-19 pandemic, historic low rates resulted in soaring personal and business savings. As a result, most banks and financial institutions that previously valued cash had a more passive attitude to deposits. However, with these savings being mostly spent, all the Canadian banks found themselves hunting for deposits in 2023.

Debt pricing continued to be at an all-time high with Canadian banks continuing their reserved sentiment due to uncertain economic conditions and inflationary pressures. In 2023, Canadian banks increased provisions for credit losses to prepare for potential credit defaults impacting their overall profitability.

Yet, the conservative approach of the Canadian banks and well-capitalized Schedule I banking sector relative to global banking peers has led to stability in the Canadian economy.

It has also ensured the Canadian economy avoided difficulties in the financial sector that occurred south of the border and in Europe. In addition, in the fourth quarter of 2023, we saw most Canadian banks work with borrowers to extend amortization periods to reduce payment shock at renewal and adjust other reporting and covenant requirements to support businesses as they battle challenging inflationary conditions.

Looking forward, although banks expect further loan loss provisions and pressure on lending, we expect credit loss provisions to peak in 2024. On the other hand, borrowers will continue to work through tighter credit conditions in 2024.

Alternative lending and private credit: A bright light during uncertain times

Alternative lending and private debt continued to provide support to businesses in 2023. Of the C$1.43 trillion loaned in Q4 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.

Many of Canada's largest pension funds also began expanding into private credit as they see the economic uncertainty in 2024 as an appropriate time in the economic cycle to commit capital to private credit. In addition, these pension funds see opportunities as major banks manage risk appetite in uncertain times. 2023 also saw Canadian banks adding resources to their asset-based lending groups as they worked to increase market share in the private lending space.

Slowing pace of private equity and M&A

Private equity and venture capital activity continued to slow in Q4 2023, with this sector experiencing a return to normalcy mirroring the pre-pandemic era of 2019. Driven by tighter capital conditions and market uncertainty, M&A activity was down about 35% in 2023. However, there continues to be a backlog of businesses in Canada that need to transition due to the intergenerational transfer of wealth. Additionally, many business owners have been holding off going to market over the past year. This has resulted in pent-up activity in the deal-making space.

Looking forward to 2024 and 2025 as economic uncertainty and rates reduce, we anticipate a rebound in M&A in 2024 and beyond, particularly in technology, healthcare, food and beverage, and all industries sensitive to the economic slowdown.

Rate cuts: When will we get there?

The Bank of Canada needs to see core inflation on a sustained path back to the 2% target and a downward momentum in core inflation to reduce rates. Although the Bank of Canada understands that a rate shock is coming for households (e.g., mortgage renewals), it will only offer relief when it is convinced that inflation is moving down sustainably.

So where is inflation headed in 2024? Looking ahead in the next three months, a majority of businesses should expect to face cost-related obstacles. As a result, they will continue to raise prices more frequently and larger than normal. Food inflation will remain high at around 4%-5% in the coming months. Housing-related expenses, notably rent and mortgage interest costs, will also continue to put inflationary pressure on the economy.

It should be noted that geopolitical conflict, slow-down in the real estate and construction sector (industrial, commercial, and retail), and collapsing demand will weigh on the Canadian and global economies, yet Canada's economy will avoid recession with forecasted GDP growth of 0.9% in 2024 vs. 1.1% in 2023.

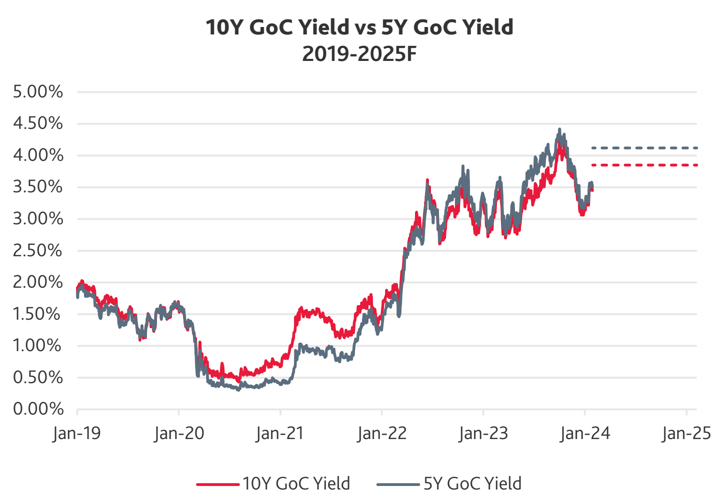
There will also be a slower pace of hiring and we anticipate for the labour market to see a slight increase in unemployment leading to additional slack in the labour market in 2024. This will result in inflation getting closer to the 2% target in 2024, with the BoC dropping its overnight rate in the third quarter of 2024 to ensure real estate and housing prices continue to stay stable through the busy spring and summer seasons.

What should businesses do?

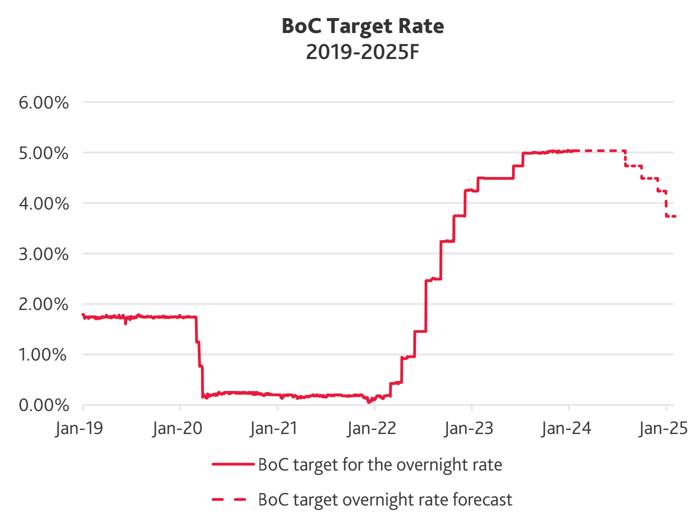
Inflation can have a big impact on a company's profitability. Therefore, it is important to keep a close eye on it and find strategies to manage rising costs.

Businesses should focus on the following in 2024 to ensure long-term success:

- Focus on three key areas: Maintaining sound financial management, cash flow forecasting, and ongoing revenue management and margins.
- Businesses should analyze business plans and forecast appropriately to make internal decisions.
- As interest rates remain high and demand slows, businesses should increasingly be looking at technology and AI to boost productivity and improve competitiveness.
- Business owners should keep an eye on the future and continue to prepare for growth when interest rates and debt pricing stabilize.



Source: Bank of Canada; BDO analysis



Source: Bank of Canada; BDO analysis

Leverage ratios and debt prices

Canadian Banks: Senior Debt/EBITDA			
	< $5M	> $10M	> $20M
Oct-23	1.75x - 2.75x	3.00x - 4.00x	3.50x - 4.00x
Nov-23	1.75x - 2.75x	3.00x - 4.00x	3.50x - 4.00x
Dec-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
Oct-23	C+2.5% - 4.0%	C+2.5% - 3.5%	C+2.5% - 3.5%
Nov-23	C+3.0% - 4.0%	C+2.5% - 3.5%	C+2.5% - 3.5%
Dec-23	C+3.0% - 4.0%	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
Oct-23	3.00x - 4.00x	4.00x - 4.75x	4.25x - 5.00x
Nov-23	3.00x - 4.00x	4.00x - 4.75x	4.25x - 5.00x
Dec-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
Oct-23	11% - 15%	10% - 15%	10% - 13%
Nov-23	11% - 15%	10% - 15%	10% - 13%
Dec-23	11% - 15%	10% - 15%	10% - 13%

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 transactional issues and other factors affecting their business. Through a holistic approach that never loses sight of the big picture, we offer strategic solutions focused on generating value for our clients.

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

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