Canada debt market report

Q3 2023

With various forces shaping the trajectory of Canada's debt market, a deep understanding of the factors at play allows investors to make informed and strategic decisions in an evolving financial environment. As we navigate the economic shift, this report highlights key trends and challenges in the third quarter of 2023.

The Canadian debt market experienced slow overall growth in Q3 2023. Year-to-date loan issuance was C$1.36 trillion, driven primarily by the demand for new money. Loan issuance increased by 5% over the prior year. This was significantly reduced as compared to the 10% 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, and other professional services sectors. These four areas made up almost 60% of total business lending in Canada.

The slower pace of lending in the Canadian debt markets was due to continued conservatism from the large Canadian financial institutions. This reserved sentiment was largely underpinned by uncertain economic conditions, inflationary pressures, and a more stringent regulatory environment.

Debt pricing continued to be high, with lenders focusing more on evaluating borrowers' uses of proceeds, developing a more stringent capital structure, and taking a more asset-based lending approach while putting downward pressure on leverage levels. Persistent tighter credit conditions were felt most strongly by small and middle-market Canadian companies. These companies, which typically cannot access large institutional capital pools, rely on debt financing from large Canadian banks or local credit unions.

Canadian banks reported mixed results for Q3 amid an increasingly uncertain operating environment. Earnings were impacted by higher provisions for credit losses and expense increases. Lending growth by Canadian banks declined by 1% on a quarter-over-quarter basis, compared to 5% quarter-over-quarter growth in Q2 2023 and 8.3% quarter-over-quarter growth on average in 2022. Several banks announced layoffs in Q3 2023, Scotiabank being the largest. The layoffs were announced amid news that the Canadian banks were restructuring lending and capital markets businesses.

Alternative lending and distressed debt

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

Of the C$1.36 trillion loaned in Q3 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.

Canadian banking landscape

A high, unprecedented level of M&A activity persisted in the Canadian banking sector, as the large Canadian banks continued to take advantage of inorganic growth opportunities in a saturated market.

On Sept. 1, 2023, Canada's Competition Bureau approved the Royal Bank of Canada's (RBC) C$13.5 billion (US$10 billion) offer to buy HSBC's Canadian unit. This is the most significant acquisition to date for RBC, Canada's largest bank.

On Aug. 2, 2023, National Bank confirmed that it would acquire the Canadian branch of Silicon Valley Bank's (SVB) commercial loan portfolio. The Canadian SVB portfolio is made up of approximately C$1 billion in loan commitments, of which C$325 million are outstanding. Much of the portfolio is focused on the technology, life sciences, and global fund banking sectors and will be integrated into National Bank's technology and innovation banking group.

In these ongoing M&A transactions, Canadian banks are working through tighter liquidity and capital constraints. In mid-September, the Bank of Montreal (BMO) announced it would close its retail auto finance business to reroute resources. This move comes amid rising delinquency rates for vehicle loans than those witnessed before the pandemic, according to data from the Bank of Canada (BoC). This highlights the strain on consumers' wallets as they also struggle to repay their mortgages in a high interest rate environment.

Looking forward, we don't expect ongoing instability in the Canadian banking landscape because unlike the United States, which consists of thousands of mostly regional banks, Canada's banking system is dominated by six large banks. Also, Canadian lending practices are conservative given stringent regulatory supervision, regular legislative reviews, and tight capital regulation.

Finally, given the current economic uncertainty and demands on capital, we anticipate continued moderated lending activity in the Canadian banking landscape for most of 2023 and into 2024.

Bank of Canada rate hikes and economic conditions

In July, the Consumer Price Index (CPI) rose 3.3% year-over-year vs. June's 2.8% increase. It is key to note that stripping out the volatile components like energy, core inflation increases in July 2023 were at their lowest levels since 2021, indicating that the Bank of Canada's rate hikes are having the desired impact.

The Canadian economy and business environment continued to perform well in Q3 despite larger macroeconomic headwinds and black swan events like the wildfires in Western Canada, flooding in Atlantic Canada, and the Port of Vancouver strike.

Gross domestic product growth stabilized and the labour market remained strong, but showed signs of moderating, with job vacancies decreasing to their lowest levels since mid-2021.

With these economic headwinds and slower pace of inflation, expect the Bank of Canada to hold rates steady with one final increase in the overnight rate in December 2023.

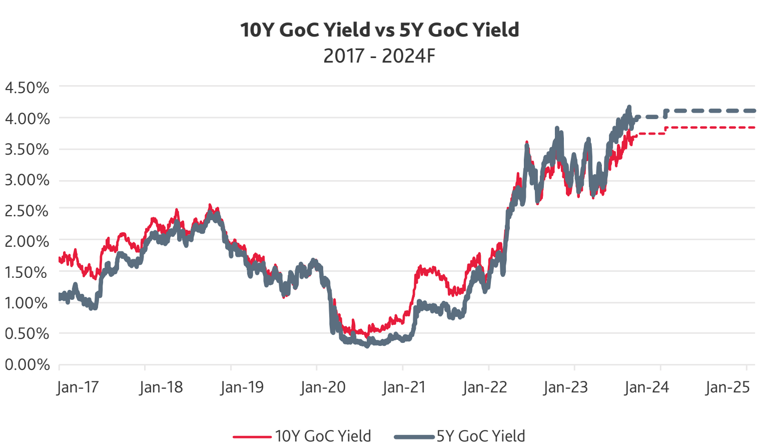
Looking forward, given the ongoing resilience of the economy and job market, expect a return to normalized economic conditions to begin in mid-2024.

M&A and private equity

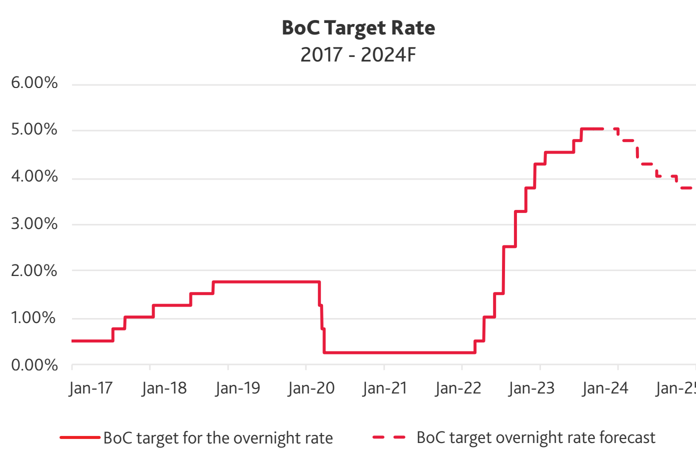
The private equity landscape in Canada continued to see a reduction in disbursed capital. The average deal size declined by 22% to C$10 million in early Q2, reflecting the industry's preference for smaller investments.

Although larger deal volume dropped, mid-market merger and acquisition activity continued forward at a strong pace. An aging Canadian population, lack of succession planning, and demand for higher wages were among the factors pressuring small and medium-sized Canadian business owners to sell their companies.

In this high interest rate environment, although it is more expensive to buy a business than it was five years ago, private equity firms and private investors are still eager to buy a good investment. As rates are expected to further decrease in 2024 and 2025, more Canadian businesses will be sold over the next five years compared to the previous half-decade.



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
Jul-23	1.75x - 2.75x	3.00x - 4.00x	3.50x - 4.00x
Aug-23	1.75x - 2.75x	3.00x - 4.00x	3.50x - 4.00x
Sept-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
Jul-23	C+2.5% - 4.0%	C+2.5% - 3.5%	C+2.5% - 3.5%
Aug-23	C+3.0% - 4.0%	C+2.5% - 3.5%	C+2.5% - 3.5%
Sept-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
Jul-23	3.00x - 4.00x	4.00x - 4.75x	4.25x - 5.00x
Aug-23	3.00x - 4.00x	4.00x - 4.75x	4.25x - 5.00x
Sept-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
Jul-23	11% - 15%	10% - 15%	10% - 13%
Aug-23	11% - 15%	10% - 15%	10% - 13%
Sept-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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