# Canada Debt Market Report

Q1 2024

Reflecting on the first quarter of 2024, the Canadian debt market continued to be affected by an uncertain economic climate, prompting Canadian financial institutions to adopt a cautious stance on lending.

This report reveals critical trends and challenges observed during Q1 and explores the necessary measures to stimulate market activity. Business leaders can gain strategic insights to help them make informed decisions for future growth and adaptation.

## Key highlights

The Canadian debt market continued to experience slow overall growth in Q1 2024. Year-to-date loan issuance was $1.5 trillion, driven primarily by the demand for new money. Loan issuance increased by 6% when compared to 2023.

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

## Availability of capital: The crunch continues amid uncertainty

Tightness continued in the availability of debt capital in Canada in the first quarter of the year. This was primarily due to the uncertain economic climate and reduced activity in the senior debt market driven by higher interest rates.

Loan-to-value ratios peaked at a maximum of 70% vs. 100% (on most lending structures) at the height of the 2021 economic boom, while leverage ratios on senior debt remained low. Debt service coverage ratios (DSCRs) on senior debt were also more conservative, with most DSCRs dropping to their lowest of 1.15x to 1.20x in 2024 vs. the lows of 1.10x on even riskier debt structures in 2021.

The one area of increased lending activity in senior bank debt was within the Canadian multi-family sector, which saw higher demand and revenues driven by the need for affordable housing. These investments saw higher lending, marking a departure from past trends. Industrial owner-occupied properties also continued to attract debt capital at competitive rates and terms.

The large Canadian financial institutions (FIs) continued their cautious stance on lending, understandable given current market headwinds. Despite their conservatism, the major Canadian banks offered a bright light to businesses to assist in uncertainty. The Canadian banks have worked and are working with borrowers to extend amortization periods to reduce payment shock at renewal and adjusted reporting and covenant requirements to support businesses as they battle challenging inflationary conditions.

Undeterred by capital and inflationary challenges, Canadian businesses were optimistic. Growth continued among businesses of all sizes, driven by higher revenues that were the result of lower capacity constraints, access to labour, increased and continued focus on sales and marketing, and competitive pricing while passing on higher costs.

However, the constraint on profit margins continued, driven by higher input and debt costs. Many businesses shifted their focus to increasing their market share in the United States and international markets to take advantage of the economic boom in the U.S., Asia, and Europe. Still, most Canadian businesses moderated their investment plans in response to higher borrowing costs.

**Looking forward, managing inflation and the course to faster rate cuts will be key to getting the market moving and lending initiated. Unless rate cuts are implemented, little is expected to change on the lending front.**

## The Canadian banks: Meeting subdued expectations

The large Canadian banks met subdued expectations in Q1 2024 across the board. Quarter over quarter, domestic bank lending was steady with no growth. Net income for all banks was impacted by expense pressures and ongoing increases in provisions for credit losses. Overall, the banks and their approach to lending to businesses focused on a proactive approach to ensure risk management.

The trend that emerged from the banking results, other than increasing provisions for credit losses, was "the hunting for deposits" by the large Canadian FI's. 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. With these savings being mostly spent, the Canadian banks refocused on gathering deposits and strengthening liquidity reserves.

**Looking forward, the Canadian FIs need the restrictive rate environment to ease to capture ongoing business and consumer lending market activity.**

## Interest rates: The Bank of Canada preaches patience while taking the steam out of inflation

While investors eagerly awaited rate cuts, the federal government and Bank of Canada (BoC) preached patience on timing.

The Bank of Canada is "boxed in" with core inflation being stuck at 2.9% in March 2024. Canadian housing costs or shelter inflation was the single largest contributor to Canadian inflation. Stronger-than-expected housing market activity risked delaying rate cuts at a speed the market is now longing for. Waiting for shelter inflation to moderate (especially if housing markets heat up again this spring and summer) before adjusting policy rates raises the risk of imparting too much damage on the rest of the economy. On the other hand, Canadian inflation expectations are also influenced by shelter costs.

**While policy rates are at their peak, given the eagerly anticipated summer housing market rebound and the continued resiliency of the Canadian economy, we don't expect a rate cut in the immediate future. The earliest we anticipate a rate cut is in Q3 2024, and it will likely occur at a slower speed than anticipated.**

## U.S. and Canadian productivity: A tale of two cities

Although the Canadian economy avoided a technical recession, the drag on the economy was more pronounced than in the United States. Quarterly growth in U.S. gross domestic product (GDP) for Q1 2024 was 1.2% vs. Canadian GDP at 0.5%. The U.S. economic juggernaut continued in Q1 2024, while economic activity was more muted in Canada. Economic activity in Canada was marked by a flatlining in consumer spending, a slowing labour market, and impacts to cyclical industries that have added next to no jobs since August 2023.

The Canadian consumer continued to face headwinds, including higher interest costs related to housing (home mortgages), depleted savings, and general inflationary pressures. Businesses, although optimistic and growing, faced similar challenges, impacting overall productivity in Canada.

The proposed change to capital gains taxation in the 2024 Federal Budget and its impact on businesses is a topic of heated discussion in the Canadian capital markets. It remains to be seen how these tax changes impact the economy and availability of capital in Canada.

The key to stimulating market growth will be the increased investment in small and medium businesses to ensure an uptick in core manufacturing in Canada. Firms will need access to incentives and credits through policy changes and skilled labour to ensure they can add economies of scale, access digital enhancements, and innovate to increase growth.

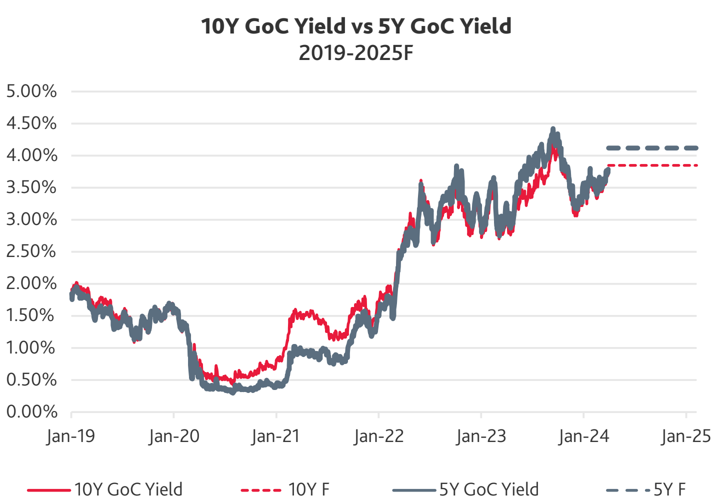
**We predict that solving Canada's productivity challenges will play a critical role in moving the debt and equity capital and labour markets.**

## A bright light: Government infrastructure spend and private funds

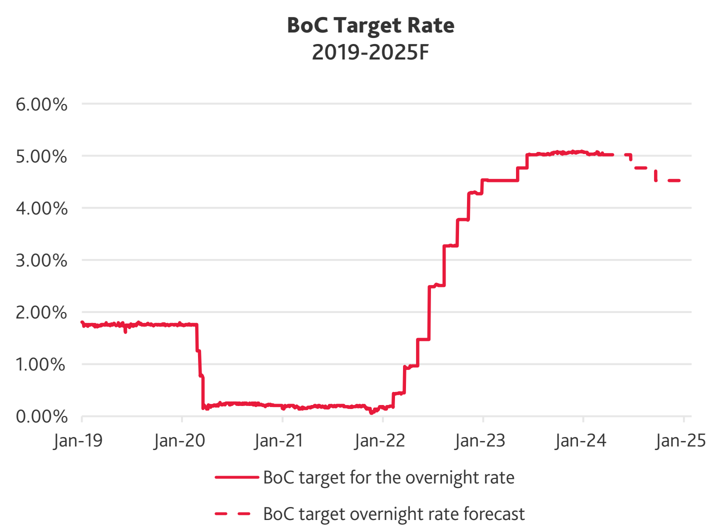
The Canadian government continues to spend on infrastructure projects, as seen in the 2024 budget. The spend aims to improve affordable housing and Canada's transportation systems. This area will continue to be a bright light for the debt capital markets as governments will need support from Canadian financial institutions and private debt funds to support this spend.

Private and alternative debt funds saw an uptick in activity in Q1 2024, and U.S. alternative lenders continued to be active in the Canadian market. There was also an uptick in the availability of capital from private equity funds, family office, and ultra-high-net-worth individuals looking to capture market opportunity in the current economic cycle.

**These funds will be a key source of support to consumers and businesses through 2024 as the market waits for the Bank of Canada to drop the policy rate to less restrictive levels.**




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 |
| Jan-24 | 1.75x - 2.75x | 3.00x - 4.00x | 3.50x - 4.00x |
| Feb-24 | 1.75x - 2.75x | 3.00x - 4.00x | 3.50x - 4.00x |
| Mar-24 | 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 |
| Jan-24 | C+2.5% - 4.0% | C+2.5% - 3.5% | C+2.5% - 3.5% |
| Feb-24 | C+3.0% - 4.0% | C+2.5% - 3.5% | C+2.5% - 3.5% |
| Mar-24 | 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 |
| Jan-24 | 3.00x - 4.00x | 4.00x - 4.75x | 4.25x - 5.00x |
| Feb-24 | 3.00x - 4.00x | 4.00x - 4.75x | 4.25x - 5.00x |
| Mar-24 | 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 |
| Jan-24 | 11% - 15% | 10% - 15% | 10% - 13% |
| Feb-24 | 11% - 15% | 10% - 15% | 10% - 13% |
| Mar-24 | 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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