# UK treasurers look to Canada's capital markets

Joanna Zapior, Tina Lai, Geoff Watson and Trevor Bateman of CIBC World Markets suggest alternative funding opportunities for UK treasurers in Canada.

Not so long ago, it used to be the case that UK treasurers looking for non-UK funding alternatives turned to the US market. Not any more. The European corporate debt market, both investment-grade, and especially high-yield, is developing at the speed of light – and so is Canada's. For this article, the Corporate Debt Research team at CIBC World Markets has tracked recent developments in Canada's capital markets. Their conclusion is that, especially on the debt side, demand is strong, particularly for new issuers, since investors are looking for higher yield and diversification in an environment of low interest rates and rapid market growth.

### *Canadian corporate debt market*

Key drivers for the development of the Canadian corporate bond market in the past four years have been reduced government borrowing (helped by balanced budgets) and a continued low-yield environment that is forcing major institutional investors to take on more risk, particularly credit risk, in their quest for higher returns. By 2000 there may be virtually no new issuance from the public sector and corporates, as a share of the Canadian fixed-income market, will reach 21%, compared to just shy of 10% in 1990 and 18% in late 1999.

There has been much development in the Canadian corporate debt market since its revival in 1996. New issuance over the past three years has doubled from 1996 levels. With $25.3bn of new issues, 1997 was a record year, both in terms of investment-grade issuance as well as high yield. While we have seen steady issuance through the year, new issuance in 1999 is tracking below the level seen in 1997 and the $24.8bn in 1998. New issuance for the past 10 months is estimated to be $19.5bn.

New issue supply has been fairly well managed, despite fears that it might come in spurts and exert pressure on spreads. Today's spreads are relatively tight compared with average levels throughout the 1990s. The spread widening in the autumn of 1998 was short-lived and its magnitude far less than that experienced in the last recession of the early 1990s (*Figure 1*).

> New issuance over the past four years has been dominated by 'A'-rated issuers

### *Wanted: name diversification*

New issuance over the past four years has been dominated by 'A'-rated issuers, who account for almost 60% of the total. 'AA' and higher-rated issuers are the second largest category, at 24%, followed by 'BBB's at 12%. High-yield issuance in the past four years was only 5% of total. We believe, with increased interest from the pension fund sponsors and their consultants in higher-yielding securities, institutional money managers will have more flexibility to buy high yield – we see this sector as the next growth area in Canada.

Six industries account for almost 80% of total issuance: financial services, infrastructure financing, pipelines, telephones, property, gas and electric utilities. Among financial services, the banks continue to dominate new issuance, but their share has been shrinking, from 40% in 1996, to 29% in each of 1997 and 1998, and down to 26% in the past 10 months of 1999. Over the past four years, several infrastructure projects – airports, bridges and highways – needed public debt financing. Infrastructure's share of total issuance was 8% each year from 1996 to 1998. It rose to 10% in 1999 and, even at this relatively low concentration, infrastructure financings have replaced pipelines and property as the second largest issuer.

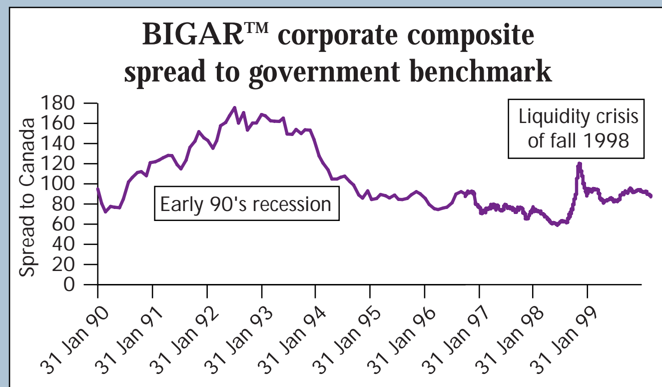
Asset securitisation is also driving the change in corporate issuance patterns since it provides alternative funding for issuers. Until 1998, securitisation was focused on commercial paper (through conduits), in part because shrinking treasury bill issuance created a receptive market. In 1995, treasury bills accounted for 75% of total public short-term debt; now they account for less than 45%. In 1998, term securitisation increased dramatically, mostly due to strong activity by the Canadian banks as issuers. Increased issuance in the asset-backed market continues to relieve the new issue supply pressure on corporate spreads that would undoubtedly appear if the same volumes were directed to the term corporate markets.

Yet another important element of the Canadian fixed-income scene is commercial paper, both corporate and asset-backed. Commercial paper outstandings have tripled since 1990, and ABS CP experienced explosive growth over the past two years, notably due to aggressive asset securitisation by regulated financial institutions, and supported by increased investor appetite for the highest-rated paper. Corporates now account for almost 20% to the total short term market while ABS CP for 17%. There are about 250 active issuers of commercial paper, whose programme sizes vary from $75m to $4bn.

### *Canadian equity market overview*

**Greater transparency** – From a new issuer perspective, the most important feature of the recent changes in Canadian equity markets is, in our view, transparency, now that the stock exchanges have reorganised, aligning themselves by market capitalisation and product type. Toronto Stock Exchange

FIGURE 1




(TSE), Canada's foremost capital market, is now clearly the exchange for larger companies. It features more than 1,400 predominantly large-capital companies. CDNX, the country's new small-capital stock exchange was formed on November 29, 1999 from the merger between the Vancouver Stock Exchange and the Alberta Stock Exchange. The Winnipeg Stock Exchange, which presently serves companies with regional interests in Manitoba and Saskatchewan, will be merged into the CDNX in 2000. Montreal Stock Exchange, which lists 534 companies, is the leader in derivative products.

TSE 300 Composite is Canada's most frequently quoted large cap equity index with four industries accounting for close to 70% of the index. (Industrial products make up 29% of the TSE's capitalisation, financial services 16%, utilities 14%, and oil and gas 9%. All natural resource sectors together account for 21% of the exchange's capitalisation.) TSE 300, despite being Canada's large cap index, does not track the performance of Dow Jones or S&P 500. Rather, for the past twenty years it has tracked quite closely Russell 2000, which suggests that Canadian equity market is more of a small cap nature by global standards. The average TSE 300 member has a market cap of about US$1.5bn, compared to US$600m for Russell 2000 and US$20bn for S&P 500. The S&P 500 price/earnings ratio has more than doubled since 1995, outpacing the 60% rise in P/E of TSE 300 and Russell 2000.

The most important compositional differences between TSE 300 and S&P 500 are natural resources and technology stocks. Commodity-related sectors account for 21% of TSE's total capitalisation, while S&P's resource weighting is only 7.5%. Conversely, high-tech stocks make up only 17% of TSE 300, but 26% of S&P 500. It is worth noting, however, that no matter what the weightings are, the performance of Canada's high-tech sector matched that of the US, with a 354% gain over the past four years, compared to 367% for the high-tech sub-index of S&P 500. However, the Canadian resource sector has lagged behind the relevant S&P sub-index since 1997, despite a concurrent 8% depreciation of the dollar.

The Canadian equity markets have improved along with the general economic recovery in North America in the second half of the 1990s. In the same way that 1997 was a record year for the Canadian corporate debt market, 1997 was a banner year for Canadian equities as $36.2bn of new issuance was completed, compared with $20.2bn in 1998 and $17.4bn year-to-date.

**Product innovation** – While the majority of issuance continues to be common equity by existing public companies, the Canadian equity market provides alternative equity funding sources as seen in a robust market for preferred shares, convertibles, trust units and initial public offerings. Issuers continue to look for innovative financing opportunities as is evident from the emergence of two new equity hybrid products this year, preferred securities and equity subordinated debentures (ESDs). In 1999, five issuers accessed the preferred securities market, raising $1.2bn and three tapped the ESD market, raising $600m.

Although total equity issuance was down significantly in the past two years, common equity issuance (excluding royal trusts and IPOs) has remained relatively flat. The most dramatic changes took place in issuance for trust units and IPOs. Trust unit issuance dropped significantly from $8.8bn in 1997 to $1.8bn in 1998 and $971m in 1999 year-to-date. The 90% decline in trust unit issuance was due to oversupply and weaker after-market performance of income funds and royalty trusts. Preferred share issuance has remained flat over the past three years with the most significant event being the development of the preferred security market, which has essentially replaced the perpetual preferred share market in Canada. IPO issuance (excluding royalty trusts) increased 18% from $3.8bn in 1998 to $4.5bn in 1999. While the dollar value of IPOs increased, the number of IPOs completed dropped by 23, with only four IPOs accounting for approximately 75% of the total for 1999. All four of the offerings were in the financial services sector, the majority being for the demutualisation of the life insurance sector.

**No longer trees and rocks** – Companies in four industries – financial services, communications and media, oil and gas, and property – made up over 50% of total equity issuance in 1997 and 1998. *Figure 2* lists the top five industries that issued equity. Financial services dominated issuance in 1999 due to a large common equity issues, and a significant amount of preferred share issuance specifically by the banks and large common equity issues by finance companies. Once again, financial services dominated 1999 issuance owing primarily to demutualisation of the Canadian life insurance industry. The replacement of issuance by companies in the metals and mining

FIGURE 2 **Top five industries issuing equity**

| 1997 | | 1998 | |
|---|---|---|---|
| Oil and gas | 17% | Financial services | 28% |
| Real estate | 14% | Communications and media | 13% |
| Financial services | 13% | Oil and gas | 9% |
| Communications and media | 12% | Real estate | 9% |
| **Metals and mining** | **12%** | **Technology** | **8%** |

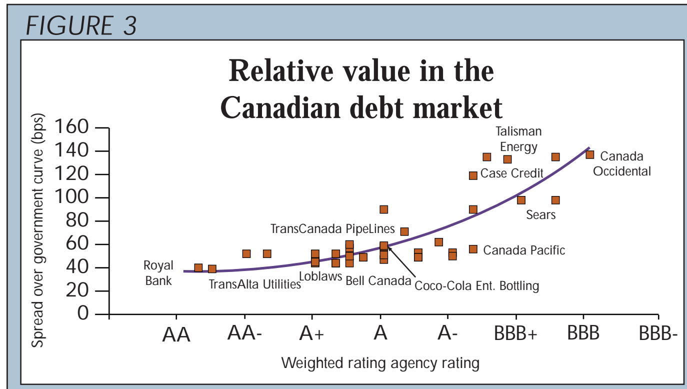
industry by technology companies reflects the changing nature of our times and the increasing financing needs that the information age has brought.

**Current market tone** – Despite the backup in underlying interest rates during 1999, the overall cost of funds remains very attractive from a debt issuer historical perspective. The Canadian bond market has recently outperformed the US, thus returning Canada/US corporate spreads to negative territory. North American bond markets are currently highly focused on the build-up of inflationary pressures, especially wage-related. We expect the Bank of Canada to match the likely Fed rate hike in early 2000. Even if this happens though, Canadian interest rates are still lower, relative to the US and the all-in costs of financing remain attractive.

Corporate spreads have been volatile in the second half of 1999 and remain subject to equity market jitters. But institutional demand, particularly for new and higher-yielding issuers, is providing good support for spreads. There is also significant interest on the part of fixed-income investors in debt/equity hybrid securities. It is worth noting that world risk remains the overwhelming force driving Canadian corporate spreads. Our analysis indicates domestic factors, such as relative supply and credit quality, long-term, have a smaller influence on Canadian corporate spreads than global events.

Volatility in the equity market has persisted through the second half of 1999, partly due to rising concerns about inflation. Valuation expansion has probably peaked in the first quarter of 1999 and further expansion in 2000 is less likely. However, moderate gains can be achieved through earnings improvement, further supported by the current global economic recovery. A substantial drop in valuation is a risk but would need a push from inflation to unfold. The risk of inflation is not extreme as modest interest rate increases should continue to moderate U.S. consumer spending and talks of increased oil production inside and outside OPEC are not likely to keep oil prices in the US$26-US$30/Bbl range that would turn inflation fears into reality.

*FIGURE 3*




***Relative value***

The relationship between risk and reward forms the basis of valuation in the corporate debt market, in much the same way as price-earning ratios provide the basis of valuation in the equity markets. *Figure 3* shows an indicative value line, created by the regression of five-year new issue spreads against the weighted rating agency ratings. The line helps to identify bonds for which the market's view of risk differs from that indicated by the average rating agency rating. Bonds that are above the line may be deemed 'cheap' whereas bonds below may be deemed more expensive. Corporate bonds are tightly priced in the 'A' rating category but significant disparities exist for lower-rated bonds. Risk is represented by bond ratings by the rating agencies while reward is represented by spread over benchmark Government of Canada bonds.

After three years of decline, TSE 300 earnings are forecast to recover to the 20% range through 2000, thus matching S&P 500 earnings momentum in the second half of this year and exceeding it in 2000. This outlook is predicated on a recovery in commodity prices and resource earnings. Improved ROE is a major target for Canadian companies, and a major swing factor could very well be the improvement of bank earnings through a concerted focus on restructuring to improve return on equity. Valuations of the TSE 300 are relatively lower than those in the US and globally.

Interestingly, even though Canadian investors have been cautious in the Canadian market, US investors have been substantial net buyers of Canadian equities. In a global recovery environment, CIBC WM Equity Research expects increased domestic and European buying of Canadian equities to join what is already taking place from US investors.

Domestic factors, such as relative supply and credit quality, long-term, have a smaller influence on corporate spreads than global events

***A Canadian who's who***

Apart from institutional and retail investors, Canadian and US rating agencies and dealers are players in the Canadian capital markets. About 150 institutional investors account for most of the buying power in the market. In term debt, money managers absorb 40% of supply, then life insurance companies at 32%, pension funds at 12% and mutual funds at 6%. Retail accounts for about 10% of the debt market.

Four rating agencies are used by Canadian fixed-income investors. Two Canadian-based agencies are Canadian Bond Rating Service (CBRS) and Dominion Bond Rating Service Limited (DBRS). Also, Moody's and S&P have gained a stronger foothold in Canada in the past five years.

According to the *Financial Post*, Canada's leading business publication, five Canadian and five US dealers lead the bulk of corporate financings, as seen in the 1998 rankings. ■

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