Are Canadian Companies Ready for a Downturn?

Description

You would think, given the global economy is in relatively good shape, that governments and corporations alike would be trimming debt rather than adding to it. Sadly, that's the furthest thing from the truth.

The federal government, which rattled off 11 consecutive budget surpluses between 1997 and 2008, will deliver an $18.1 billion deficit in fiscal 2018. Thereafter, it plans to average a deficit of $15 billion in each of the next four years. Meanwhile, the Ontario government plans to run an $8 billion deficit in the coming fiscal year after taking an entire decade to balance the books.

Down in the U.S. where the country is running at full employment, tax cuts and higher spending has America grappling with record government and corporate debt.

"If they can't balance the books now, at this very strong stage of the cycle, they may never be able to," said Doug Porter, chief economist at **Bank of Montreal** in the *Globe and Mail*. "And as governments purposely weaken their finances now, it gives them less manoeuvring room and less firepower in the next downturn … I don't think we can count on the consumer to pull us out of the next downturn."

Corporate debt keeps rising

As recently as 2006, fewer than $0.19 of every dollar of operating income was required by Canadian non-financial companies to service their debt. Today, that's risen by 26% to $0.24 of every dollar of operating income.

At a time when Canadian companies should be debt free, or close to it, many are piling it on. Down in the U.S., total corporate debt outstanding has tripled over the past decade, putting financial leverage at levels higher than they were prior to the 2008 economic crises.

Admittedly, with interest rates much lower today than they were back then, it's easier to justify a higher level of debt, but when the economy falters, as it always does, investors will be left holding the bag.

So, how ready are Canadian companies for the next downturn? Like the last one, we probably won't truly know until it's upon us.

Nonetheless, we can look at the financial situation of large-cap companies such as **Restaurant Brands International Inc.** (TSX:QSR)(NYSE:QSR) to get an idea.

Growth through acquisition

If you follow Restaurant Brands, you know that it was called Burger King until 2014, when 3G Capital, with the help of Warren Buffett, did a tax-inversion deal to buy Tim Hortons for $12.5 billion. At the time of the deal, corporate tax rates were lower in Canada, but not now after the Trump tax cut.

Burger King's last quarterly report was the third quarter ended September 30, 2014. At the time, it had US$2.9 billion in long-term debt, interest payments of US$152 million through the first nine months of the year, and operating income of US$132 million.

In its first full year after Burger King merged with Tim Hortons to become Restaurant Brands International, it had US$8.5 billion in long-term debt, interest payments of US$478 million, and operating income of US$1.2 billion.

Clearly, the Tim Hortons purchase helped its operating income, which increased almost 10-fold after the deal.

Finally, in 2017, Restaurant Brands acquired Popeyes Louisiana Kitchen for US$1.8 billion. At the end of fiscal 2017, Restaurant Brands had US$11.8 billion in long-term debt, interest expense of US$512 million, and operating income of US$1.7 billion.

In the span of 39 months, Restaurant Brands has increased its debt by 307%, while upping its operating income by 1,188%. That's not too shabby.

However, since the end of 2015 (the company's first 12-month fiscal year), long-term debt has increased by 39%, while operating income increased by just 42% — not nearly as impressive as 1,188%.

Is corporate Canada ready for a downturn?

Who knows? But what I do know is that there are plenty of examples on the TSX of companies like Restaurant Brands that have piled on the debt, foregoing repayment for dividends, something that benefits 3G Capital immeasurably more than individual investors.

When the you-know-what hits the fan, 3G Capital will have billions in dividends, while the average investor will have very little to show for their equity.

I'm not saying that's going to happen, but if it did, that would be the result.

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Date
2025/07/04
Date Created
2018/03/28
Author
washworth