

May 19, 2020

COVID-19 Crisis Business Continuity and Trade Working Group

Communique #7: Financing bridge needed to protect at-risk sectors as Canada faces a long, hard road to recovery

To help Canadian governments confront the public health and economic crisis resulting from COVID-19, the C.D. Howe Institute has established several working groups to rapidly distill expert policy advice. The Working Group on Business Continuity and Trade is co-chaired by Dwight Duncan (Senior Strategic Advisor at McMillan LLP and former Ontario Minister of Finance) and Jeanette Patell (Vice-President of Government Affairs and Policy for GE Canada). Its membership includes industry experts and economists. Daniel Schwanen, Vice-President, Research, and Grant Bishop, Associate Director, Research, at the Institute support the group. Meeting weekly, it identifies and prioritizes policy challenges and communicates members' views in published communiques. The group met on May 5 and May 12, 2020.

At these meetings, the working group discussed the risks and headwinds for economic recovery and the action that is needed to prevent “scarring” in key economic sectors. If businesses face distress and a disorderly wave of insolvencies, the ability of the economy to rebound will be impaired and the recovery slowed. Without an effective “bridge”, the disruption of productive capacity will further slow the recovery – even as restrictions on workplace activities are lifted.

Working group members recommended the following:

- Governments must carefully consider how to structure sustained support required to bridge companies through a protracted period of depressed demand in various major sectors.
- With headwinds facing recovery in many sectors, likely for years to come, governments will need new and creative channels to provide economic stimulus.
- The private sector must remain the primary source of credit; however, governments should identify where impaired access to liquidity could disrupt key productive capacity, as well as complement private lending where credit access is bottlenecked and disorderly insolvencies would hinder economic recovery.
- The air travel, agrifood, petroleum, tourism and accommodation sectors represent significant shares of the Canadian economy and each face a likely protracted plunge in demand. Without



May 19 2020

credit support to “bridge” companies in these sectors, a large portion of production capacity might be lost, resulting in knock-on effects in the wider economy.

- Nonetheless, governments must clearly identify the particular market failures that policy is targeted to address, and interventions should not displace market forces. Government backstops should not displace private creditors, impair efficient, pro-competitive consolidation or forestall restructuring of distressed companies.
- Although awaiting details for eligibility and structuring, the federal government’s Large Employer Emergency Financing Facility (LEEFF) appears a good measure with broad availability across sectors and appropriate conditions to help large companies access bridge financing.
- With increasing risk of a shift towards protectionist policies internationally, Canada must remain a champion of open borders and integrated trade. However, Canada may need an “elbows up” defence to ensure key Canadian industries survive amid restructuring of global value chains.

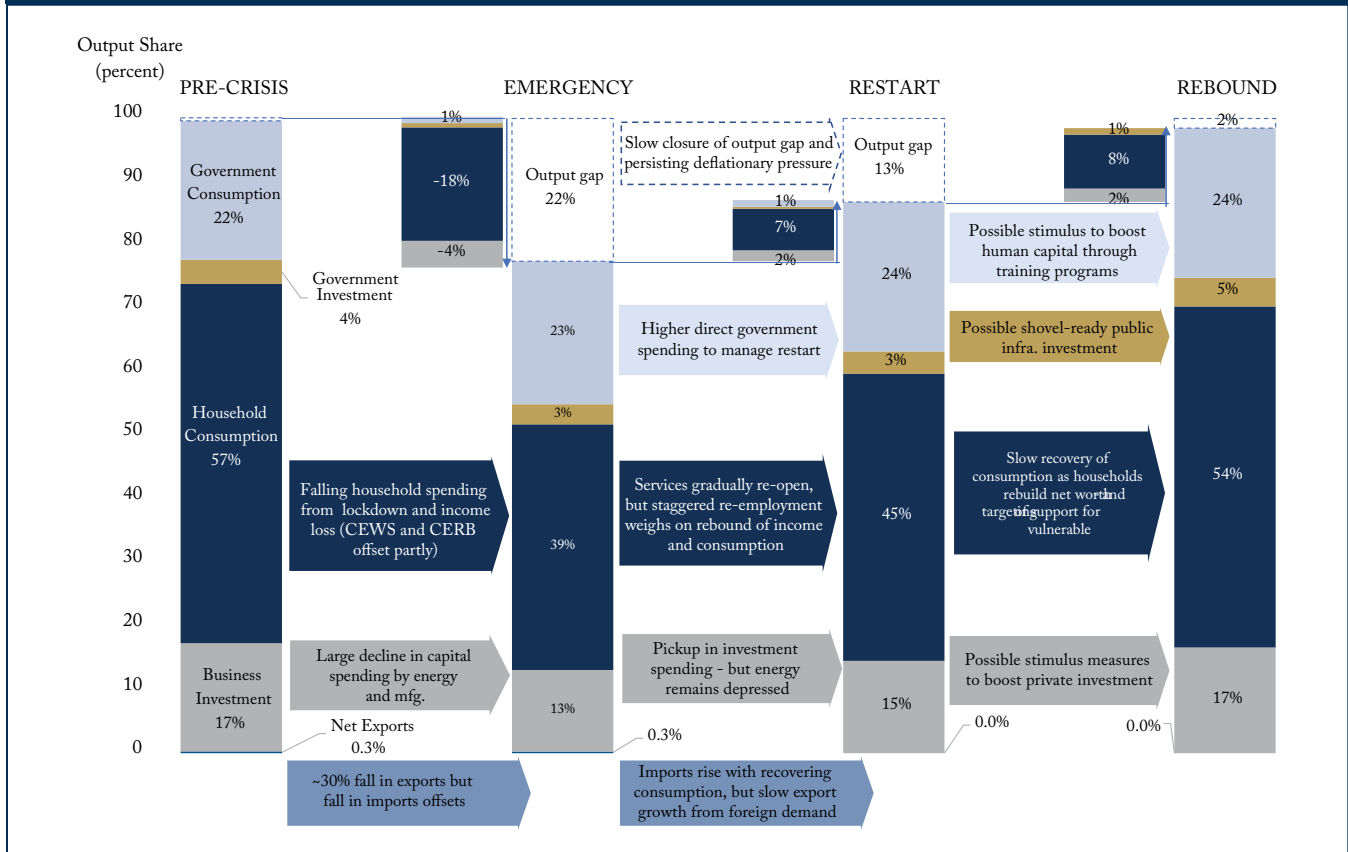
Recovery Will be a Long, Hard Road

Working group members expect the period for recovery will be long and difficult. Governments are now restarting the economy and easing shutdown restrictions gradually. Provincial governments’ announced roadmaps for return to work help anchor expectations, but timelines remain tentative and much uncertainty remains around the containment of the COVID-19 virus. Uncertainty will continue to drag on economic activity. Even where allowed to return to work, many businesses and households face greatly diminished demand.

Without extraordinary and effective stimulus, Canada’s economy will face idle capacity and high unemployment for an extended period. While not a forecast and not projecting timelines, Figure 1 illustrates an example pathway through restart and recovery to help conceptualize the headwinds to the recovery of Canada’s economy. With the estimated plunge in household spending and private investment, the illustration shows that Canada’s output gap would remain wide, absent other measures to boost aggregate demand.

The fall in household consumption has been the greatest downdraft to Canadian aggregate demand. Household spending will be slow to recover as physical distancing measures continue and households’ incomes remain depressed. Even well into recovery, households will need to save rather than consume as they rebuild their net worth.

Figure 1: Estimated Crisis-driven Contraction and Example Restart/Recovery Pathway



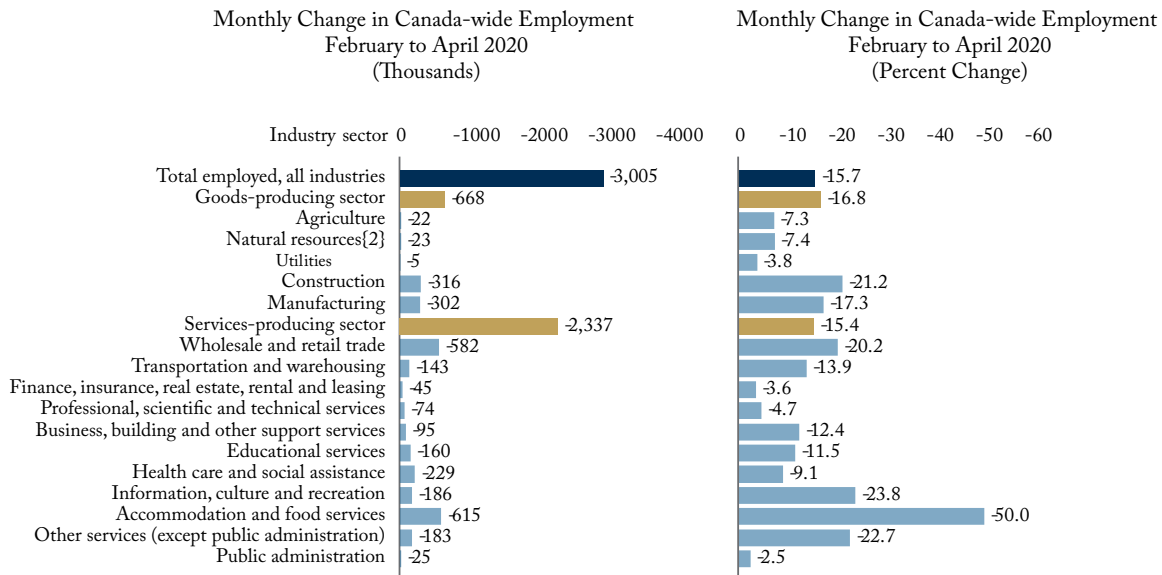
The steep contraction in Canada-wide employment since February (Figure 2) indicates severe impacts on household incomes and underscores the pullback in output across the economy. Aggregate credit card transaction data, published by RBC, indicate an over 30 percent contraction in household spending.¹ Reduced consumption on durable goods is reflected in the 75 percent year-over-year decline in Canada-wide motor vehicle sales in April.²

1 Guldimmann, Colin. 2020. COVID Consumer Spending Tracker. May 4. RBC Economics. Available online: https://thoughtleadership.rbc.com/covid-consumer-spending-tracker/?utm_medium=email&utm_source=salesforce&utm_campaign=special

2 See: "Monthly Motor Vehicle Sales in Canada" on the C.D. Howe Institute COVID-19 Economic Dashboard. Available online: <http://dashboard.cdhowe.org/#mv>

May 19 2020

Figure 2: Canada-Wide Employment Contraction since February 2020



Source: Statistics Canada Labour Force Survey.

Now expecting multi-year horizons for depressed demand in export markets, sectors like oil & gas and manufacturing are dramatically reducing capital expenditures. Exporters face diminished volumes and prices, which will drag on the net export component of aggregate demand. In turn, expecting reduced returns for an extended horizon, such exporters will reduce their capital expenditures. This pullback in private investment will further drag on aggregate demand.

Credit Support Critical to Avoid “Scarring” – But Must not Displace Market Forces

Governments must also address the risks of long-lasting disruption to productive capacity – so-called “scarring” – from a disorderly wave of insolvencies. Business distress and diminished output in key sub-sectors can have knock-on effects on related industries – such as suppliers, service contractors and downstream manufacturing/processing.

May 19 2020

Canada could lose agrifood manufacturing capacity without stable farm production

Working group members emphasized the importance of Canada's agrifood industry as a channel of export-driven growth and highlighted the threat if its operations and value chain is decimated. The federal government could simplify its agricultural supports, targeting temporary subsidies based on lost revenue and volumes.

In Canada's agrifood industry, much manufacturing capacity serves export markets and depends on a stable annual supply of produce. If financial distress for farmers results in depressed crop and livestock production for several years, agrifood manufacturers will look abroad for new investments and reorient supply chains away from Canada. Facing large losses on this year's crops, farms lack cash flow to fund cultivation in the upcoming growing season.

Canada's agricultural risk management programs have been arguably designed for the economics of the grain sector, and recently announced farm credit support appears cumbersome for growers of produce and livestock. With produce growers already selling at low margins, the virtual elimination of revenues as domestic and export demand collapses will impose steep losses. Up to 15 percent of Canada's farms may be at risk of insolvency and closure. The loss of this agricultural capacity could cause the departure of agrifood processing/manufacturing capacity to jurisdictions with stable production. Investments are made for the long-term and, if agrifood producers shift production elsewhere, it will be difficult to win back to Canada.

As well, Canada's federal government has been slow compared to other countries in establishing programs to buy up and distribute perishable products. The disposal of produce – for example, unused potato stocks – could also have a significant ecological impact and compromise future planting. In contrast to Canada, the United States has rapidly extended and established programs for purchase and redistribution of food stocks to avoid the financial and ecological costs of disposing of current inventories.

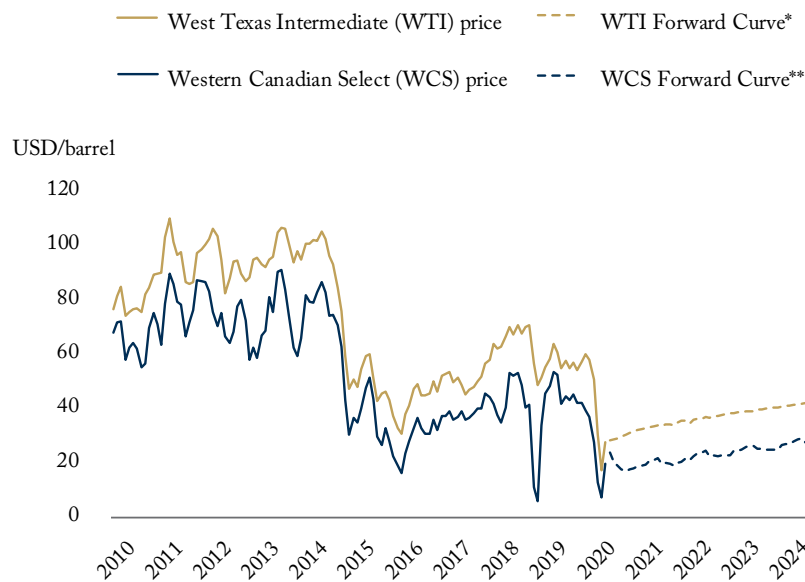
Even with near-term credit bridge, petroleum sector needs “view to the other side”

Canada's petroleum sector faces forecasts for depressed crude oil prices for years to come. Even as the shock to global petroleum demand eases, competition from low-costs exporters will likely weigh on oil prices.

Figure 3 exhibits the outlook for benchmark oil prices in the forward market. Based on futures contracts to December 2024, markets do not expect prices of Western Canadian Select (the common

May 19 2020

Figure 3: Benchmark Oil Prices and Forward Curve



* Forward prices as of May 15, 2020.

** WCS forward prices computed based on index for discount to WTI.

Sources: BNN Bloomberg, NYMEX.

benchmark grade of heavy oil produced by the oil sands for delivery at Hardisty, Alberta) to exceed USD 30 per barrel.

At these prices, many producers will not be economically viable, having extraction costs per barrel greater than that price. Other, more efficient producers could profitably produce at these prices but face borrowing constraints to meet near-term cash flow obligations.

“Bridge” support for the sector will help preserve production capacity and employment. This will ensure that the sector is able to “turn on the taps” as demand recovers and expand takeaway for access to other markets. As the resource owner, provincial governments have particular interest in capacity for efficient petroleum production that maximizes revenues over the reserve life.

May 19 2020

Working group members highlighted differences between petroleum producers' cost structures, balance sheets and access to credit. Many large, integrated oil companies entered the crisis with robust balance sheets, resilience from diversification across upstream and downstream activities, financial hedging to near-term price swings, and available credit facilities. In contrast, facing a plunge in netbacks on oil sales and immediate cash flow constraints, many smaller operators and service companies have struggled to access credit and meet financial obligations.

Specific support for petroleum producers could take the form of a loan based on forward sales of future production. Greg Pardy of RBC Capital Markets and Brian Livingston have each advanced a proposal for a "shut and swap" program structured along these lines.³

Such a program – effectively an unsecured loan based on forward prices for presently shut-in oil production – would place taxpayer funds at risk. The horizon of support is also a major question: the longer the duration of support, the greater the taxpayer risk and the potential interference with market forces. For example, certain working group members raised the possibility that access to subsidized credit could forestall consolidation within the sector.

For any credit, governments will need to verify that producers receiving funds would likely be viable at the maturity of the loan. Governments would need to screen potential borrowers based on the strength of their balance sheet and operating costs per barrel in order to verify that production would be economic at future prices and producers would have sufficient cash flow to cover the additional debt. Working group members were cautiously complimentary of the federal government's announcement for establishment of the Large Employer Emergency Financing Facility (LEEFF).⁴ Many details remain undecided: First, it is unclear how the support would be structured – whether as loans to complement private-sector credit or as partial guarantees. Second, the federal government lacks in-house capacity to itself conduct the necessary due diligence and execute such transactions.

Nonetheless, LEEFF has been long-awaited, and working group members expect that this will help backstop the petroleum sector. If properly rolled out, LEEFF can address immediate credit constraints

3 Livingston, Brian. "Shut & Swap can be a lifeboat for Canada's oil producers," C.D. Howe Institute. April 15. Available online: <https://www.cdhowe.org/intelligence-memos/brian-livingston-%E2%80%93-shut-and-swap-can-be-lifeboat-canada%E2%80%99s-oil-producers>

4 Government of Canada. 2020. "Prime Minister announces additional support for businesses to help save Canadian jobs," May 11. Available online: <https://pm.gc.ca/en/news/news-releases/2020/05/11/prime-minister-announces-additional-support-businesses-help-save>

May 19 2020

for businesses that might otherwise face disruption and loss of productive capacity. Certain working group members underscored that taxpayer funds should not displace risk capital. For example, the stated constraints on executive compensation, dividends and share repurchases may provide effective screening to ensure that any companies who access this financing are in pressing need of these funds.

As well, certain working group members affirmed that the required commitment for disclosure of material climate-related risks is an appropriate requirement. Such climate reporting has already been adopted by Canada's major petroleum producers. As emphasized by the Financial Stability Board's Task Force on Climate-related Financial Disclosures, physical risks to assets from climate change and commercial exposure to decarbonization policies represent material factors for investors to assess a company's long-term financial viability.⁵

Looking forward, Canada's petroleum sector faces a difficult horizon. Governments must design any support with robust financial criteria, appropriately calibrated duration and an exit plan that limits taxpayer exposure. Governments should not impede efficient consolidation within the petroleum sector or displace private creditors. Where complementing private credit, governments must conduct expedient but rigorous due diligence and should not support firms with dubious economic viability – even at future prices. Consolidation and vertical integration will enhance scale economies and increase resilience for Canadian petroleum producers.

However, any near-term credit support will add to the sector's debt levels. New equity will be required to rebalance companies' capital structures. Alongside any near-term credit support, governments must ensure that companies and their shareholders understand the path forward for Canada's petroleum sector.

Access to equity capital will be critical for Canada's petroleum sector to invest in new, more efficient facilities and lower-emission technology for extraction, processing and downstream petrochemical manufacturing. Government must be transparent around its planned long-term path for carbon pricing and regulatory requirements for the petroleum sector. Clarity is essential for the petroleum sector to plan its investments accordingly and anticipate the returns for investments in emission-reducing technologies like carbon capture, utilization and storage (CCUS). Regulatory uncertainty will

⁵ Task force on climate-related disclosures. 2017. *Final TCFD Recommendations Report*. Available online: <https://www.fsb-tcfd.org/publications/final-recommendations-report/>

May 19 2020

discourage the equity investment that petroleum producers require to sustainably emerge from this crisis.

Tourism sector faces prolonged slump and loss of capacity

For tourism, many in this sector now expect that any return to normal will take years. Figure 2 exhibits the 50 percent decline in employment – over 600,000 jobs lost – for the food services and accommodation sector. These businesses have been rapid to close but re-opening will require significant lead-time – particularly to restock, re-hire and re-train new employees. The tourism sector involves a high share of small and medium enterprises which lack the scale to spread increased fixed costs for implementing health and safety measures and to survive an extended horizon of depressed demand. While large hotel chains and operators may be more resilient, the attractiveness of tourism to Canadian destinations will depend on an ecosystem of smaller players to offer unique experiences to visitors.

Near-term prospects for any quick rebound are poor and there is a likelihood that this sector's ecosystem of small businesses will be shuttered, dampening the long-term capacity. Facing the likely loss of the upcoming summer season, these businesses will hibernate at best and more likely close in order to avoid ongoing fixed costs and lack of revenue.

First, in most provinces, the sector faces a continued lack of certainty about the timelines and pre-conditions for re-opening. The differing pace for easing restrictions between jurisdictions is also a challenge for tourism: even if operators in a given province can open, potential visitors may still face restrictions in their home provinces and be unable to travel. Major operators are implementing safety protocols and will communicate these measures to potential travellers, potential travellers will likely remain precautionous.

Second, operators face a near-term labour supply challenge. As has been highlighted by the C.D. Howe Institute's Crisis Working Group on Household Income and Credit Support, the availability of the Canada Emergency Response Benefit (CERB) creates a potential disincentive to accepting work – particularly in service sectors like accommodation and food services.⁶ The wage premium required to secure labour will be a challenge for operators. The federal government must also consider how to

6 Crisis Working Group on Household Income and Credit Support. *When the Smoke Clears: Tackling Disincentives to Work*. C.D. Howe Institute. April 27. Available online: <https://www.cdhowe.org/council-reports/when-smoke-clears-tackling-disincentives-work>

May 19 2020

ramp-down CERB in order to encourage re-employment as the economy re-opens and workplaces put safety measures in place.

Third, even as governments ease restrictions, demand for accommodation and food services will not likely rebound at a quick pace. Most tourism spending is domestic and stateside visitors propel foreign visits. In the near-term, physical distancing will continue. However, even if and when the virus is contained or a vaccination available, households will likely deprioritize discretionary spending on travel as they rebuild net worth. Many operators will lack the necessary occupancy or volumes to cover fixed costs.

How Does Canada Win in an Increasingly Protectionist World?

This working group previously underscored the importance of championing open trade through this crisis.⁷ Access to foreign markets for inputs and sales of exports is essential for a relatively small economy like Canada. Learning from this crisis, companies will also want to ensure that they are buffered against shortages of intermediate inputs. However, the need for resilient supply chains favours diversification rather than domestication of suppliers.

As well, the current crisis underscores the importance of ensuring stockpiles and manufacturing capacity for certain critical supplies. But establishing domestic production capacity for many imported goods would be impractical and economically inefficient.

Nonetheless, Canadian policymakers must be conscious of a worrisome tide of zero-sum thinking among certain of our trading partners. While governments have a poor record of “picking winners” through industrial policy, policymakers must be attuned to loss of systemically important companies and production capacity.

Governments could intervene to support such large companies through distress and restructuring – for example, where a company plays a lynchpin role as a purchaser or supplier and its closure threatens many other businesses. Similarly, as exhibited in the agrifood and petroleum sectors, governments may

⁷ Crisis Working Group on Business Continuity and Trade. *Canada Must Be Champion of Open Trade*. C.D. Howe Institute. April 9. Available online: <https://www.cdhowe.org/council-reports/canada-must-be-champion-open-trade-cd-howe-institute-crisis-working-group-business-continuity-and>

May 19 2020

need to provide targeted near-term support to preserve production capacity, even while ensuring market forces drive consolidation and scale for long-term resilience.

With outlook for depressed demand for many goods over an extended period, companies will scale and strategically rationalize their footprint. Industries will face pressure to consolidate many activities geographically to reduce costs and locate production nearby to sources of inputs and major downstream markets. If Canada loses key production capacity to clusters abroad, these industries will be difficult to win back and the Canadian economy may face an even longer road to recovery. Policymakers will face difficult, imperfect and inevitably politicized choices about what Canada's economy will look like after this crisis – and which bridges should be built to get to the other side.

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