Headwinds & Tailwinds

March 2022

A look at the opportunities and challenges facing Canadian businesses.

AVISON YOUNG

Welcome to the first edition of **"Headwinds & Tailwinds"** a summary of a handful of the opportunities and challenges Canadian businesses are facing today. Over the last couple of years, we have seen the value proposition to customers, approach to the market, employment needs, distribution, and complexities related to inflation change the direction of businesses, unlike any other recent time.

As businesses navigate opportunities and threats, our objective of **"Headwinds & Tailwinds"** is to help decision-makers with the following questions:

1. What are some key capital and operational challenges business owners need to be aware of what to watch for.
2. If you are considering selling your business what are key inputs on market conditions, timing and best positioning.
3. What is my businesses ability to access capital to grow or recapitalize, and what is the best path forward.

The goal of the Avison Young M&A Business Advisory team is to help business owners navigate corporate strategic decisions making and execution through M&A advisory and debt capital raises while best positioning companies with economic thought leadership. If you require additional information or would like to discuss any items contained in this report, contact information is on the back page of this report.

The Canadian business landscape

Over the past two years, Canadian business owners have been challenged beyond belief, transforming many of them into hardened warriors. Thankfully, certain headwinds are abating but others are gaining speed. While business risks (i.e. headwinds) tend to dominate the headlines, there are a number of crucial tailwinds that should not be dismissed. In this document, we highlight some key headwinds while also reiterating important tailwinds in hopes of helping business owners navigate the road ahead.

Headwinds

- Supply Chain
- Inflation & Interest Rates
- Workers & Wages

Tailwinds

- Capital Access
- Strong M&A Market
- Consumer Spending & Savings

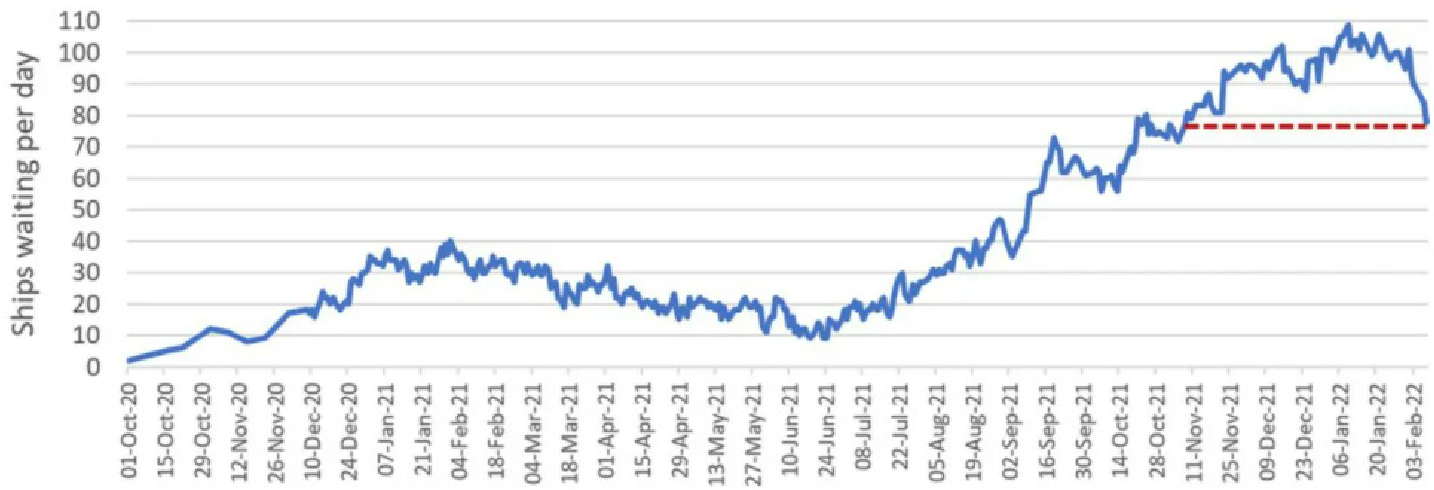
Headwind | Supply chain remains broken

Supply chain backlog showing no signs of clearing up

Recent updates

- Over 80% of global freight congestion is in the U.S. with over half of that on the U.S. West Coast.
- At its peak, container congestion has removed 10-15% of capacity in the system.
- West Coast ports have seen a significant drop in ships waiting to port, but on the flip side, congestion is increasing on East Coast.
- Increase in the number of companies looking to air freight but this is expensive and space is limited as air traffic remains subdued.

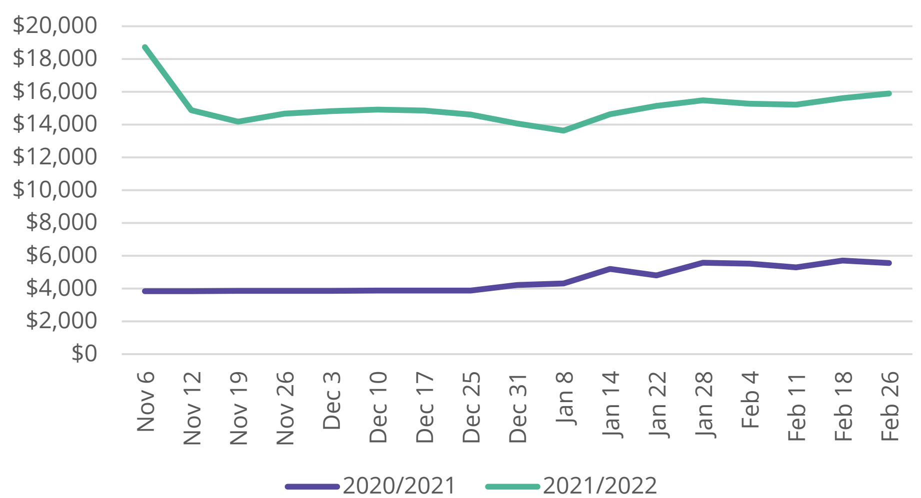
West Coast Congestion: LA and Long Beach Container Ships Waiting to Port



What to watch for

- Leading indicator of an improvement in the system are market rates for container shipping. China to West coast remains extremely elevated compared to levels one year ago.
- Further disruptions in China on the back of COVID-zero policies are impacting port activity and product manufacturing.
- West Coast port labour contracts are due for renewal in July. Last round of negotiation was difficult. Workers positioned for significant wage increases which will be passed onto importers.

China to U.S. West Coast Freight Costs (year over year)



How this problem is solved

- Hard to see a single solution having a material impact. Will be a multitude of factors to slowly normalize the backlog.
- Largest impact will be a material reduction in product focused consumer spending.
- Increasingly likely that supply chain won't normalize until late 2022 or into 2023.

Source: Freightos, Avison Young

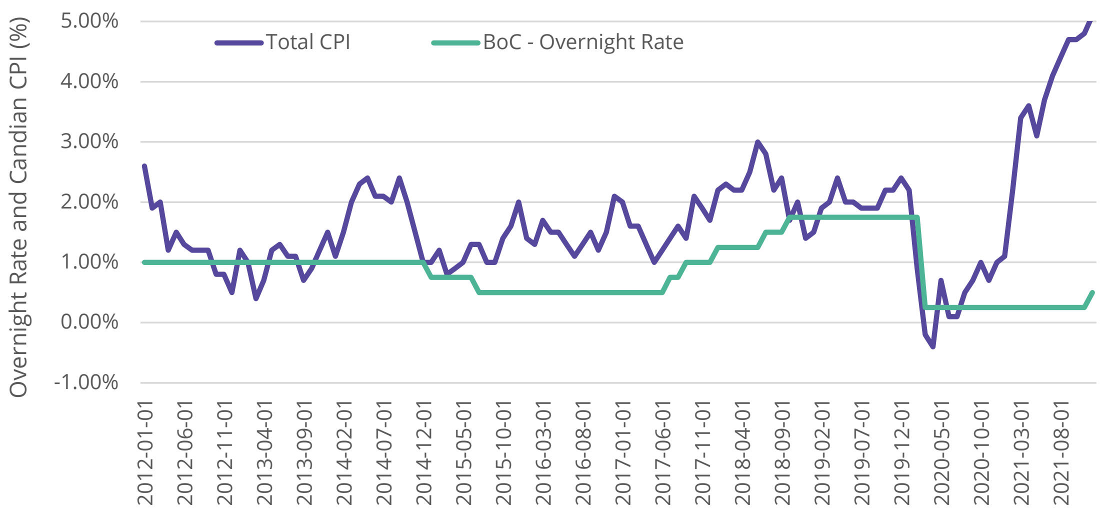
Headwind | Interest rates & inflation

The inflation horse is out of the barn

Recent updates

- Canadian Consumer Price Index (CPI) continues to hit multi-decade highs, far exceeding the Bank of Canada's 2.0% target.
- Bank of Canada has started to increase the overnight rate with a 25 basis point increase seen last week. U.S. Federal reserve is expected to follow suit in the upcoming meeting. Recent geopolitical events have tempered some of the rate hike expectations through the year as central banks are tasked with navigating a very dynamic situation.

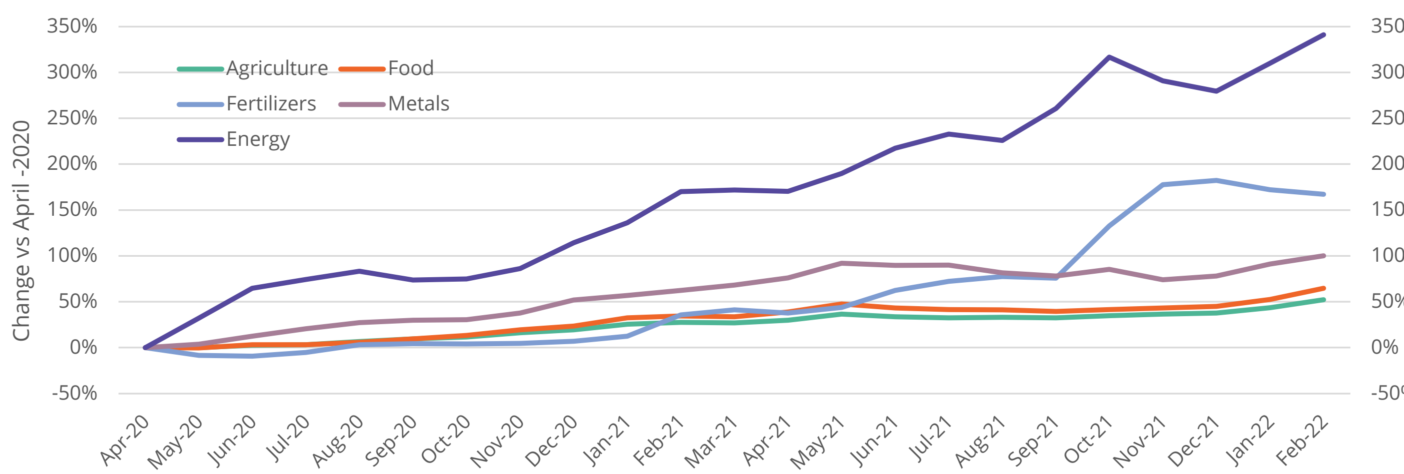
10-year History on Overnight Rates and Canadian CPI



What to watch for

- Rate hike expectations are being built into the market through Central Banks communication. Key drivers of the stock market are how those rate change expectations move over time. Geopolitical factors will play a crucial role.
- Supply chain certainly elevating prices in the near term but inflation likely remains elevated on the back of increasing key input costs (energy, fertilizer, metals, etc.) and wage increases.

World Index of Select Input Prices – Continue to move higher



Source: Bank of Canada, World Bank, Avison Young

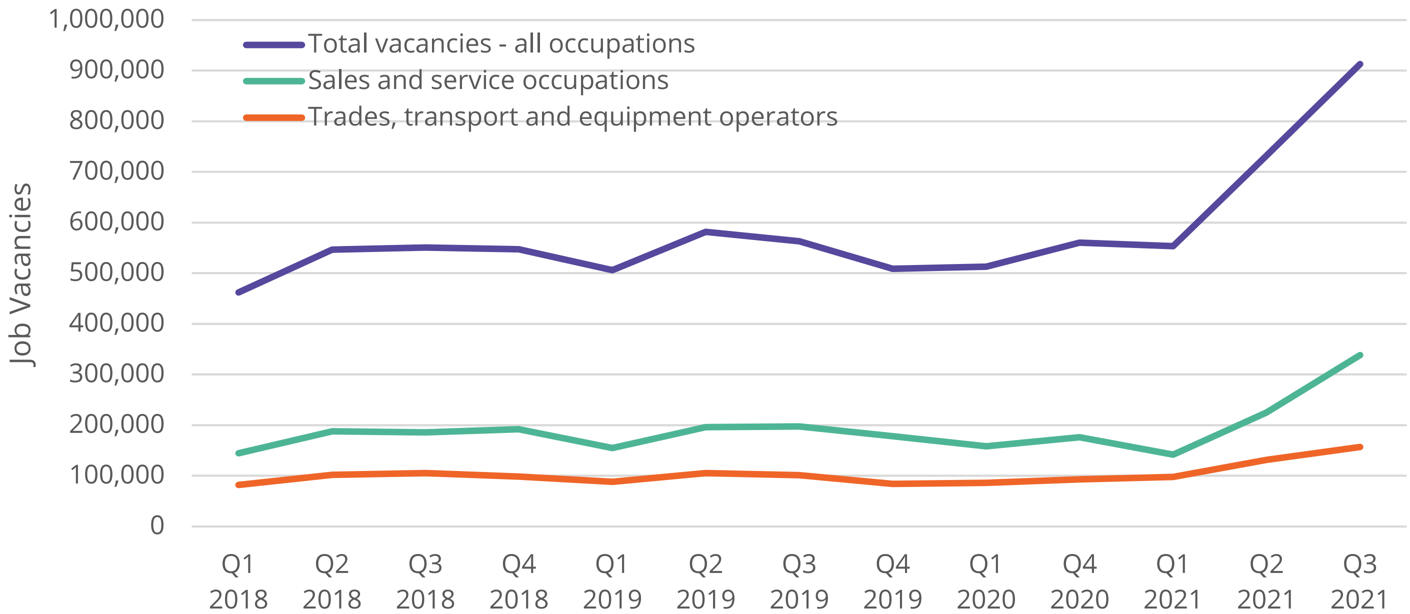
Headwind | Job vacancy & wages

Labour costs poised to move higher

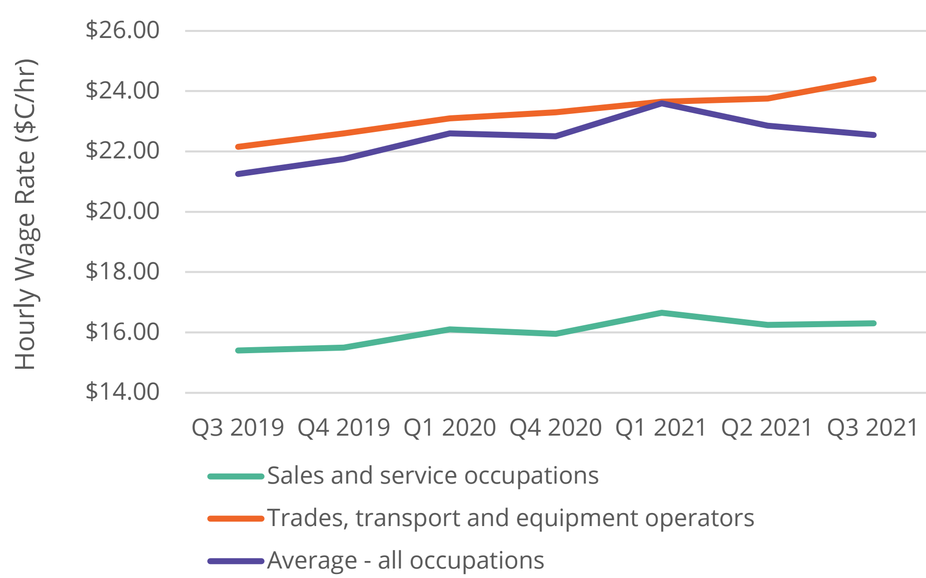
Recent updates

- Most recent Canadian job vacancy data indicates vacancies (i.e. unfilled job postings) rose 45% quarter over quarter and 65% over the past six months.
- Increase in vacancies has been led by the service sector with vacancies up 140% when comparing Q3/2021 vs Q1/2021.
- Compounding issues related to the supply chain, trade and transport vacancies are up nearly 50% over the past 6 months.

Canadian Job Vacancies – Up 65% in past 2 Quarters



Average Hourly Wage Rate – Poised to Move Higher



What to watch for

- The data indicates little movement in wages across Canada but we suspect this will shift materially higher to offset the vacancies.
- Latest U.S. employment data indicated a material increase in the number of workers taking positions in warehousing – we suspect Canada isn't too far behind.
- Canada will need to work through the sluggish December/January job market to get a clearer picture.

Source: Bank of Canada, World Bank, Avison Young

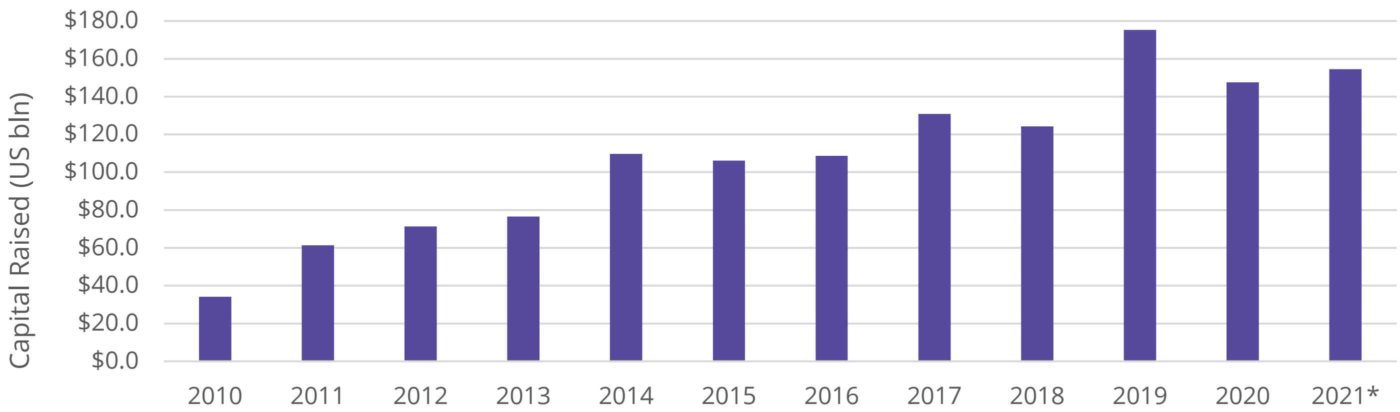
Tailwind | Capital access remains strong

Historical amount of capital waiting to be put to work

Private capital

- Capital flowing into the North American private capital space remains robust with nearly $500 billion raised in 2021. Fundraising growth sits at a 7% 5-year CAGR.
- Of the funds raised, mandates are focused on buyouts and growth equity (~70%) which will continue to support and capitalize strong businesses. Capital waiting to be put to work AKA "Dry Powder" is at historical level despite 2021 being a record year for buyout deal activity.
- Middle market becoming increasingly competitive for private equity money as fund managers are seeking out higher risk adjusted returns. Chart below highlights North American PE capital focused on mid-market.

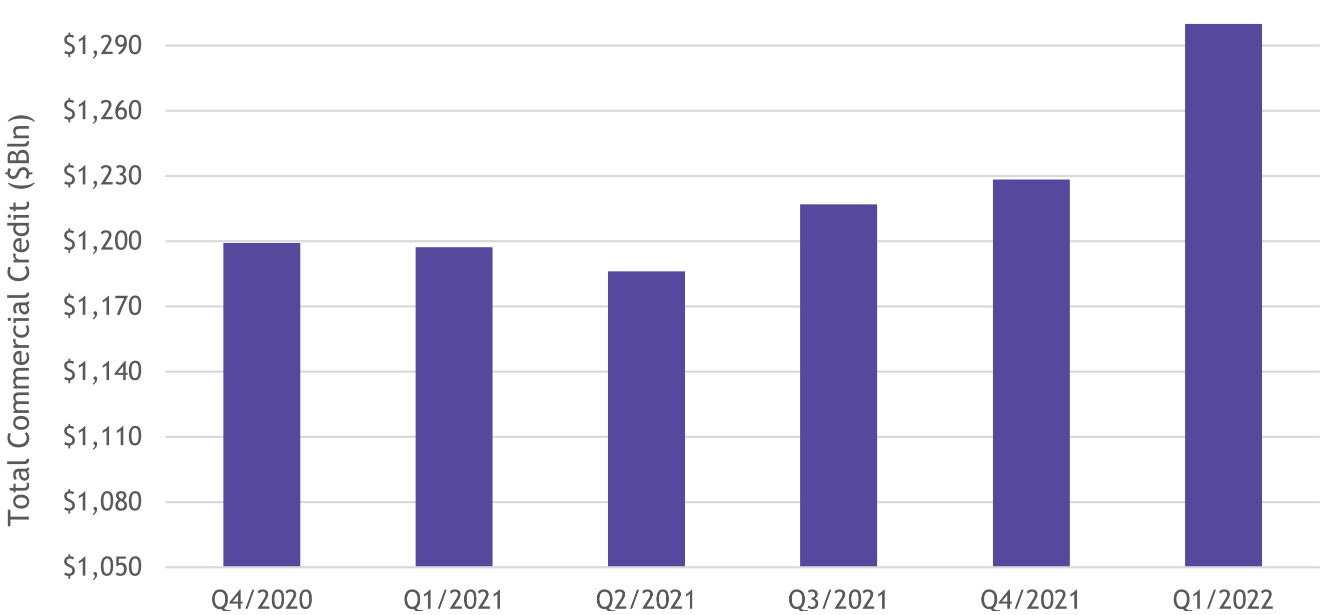
North American Private Equity Fundraising – Targeting Middle Market



Canadian bank lending

- Canada's major banks are extremely well capitalized and as a result have been aggressively increasing their commercial loan books lending to Canadian businesses.
- The most recent financial results show that Canada banks grew their commercial credit at a rate of 6% meaning nearly a $80 billion of commercial credit was extended during the quarter, nearly triple the historical growth rate.

Canadian Banks – Total Commercial Credit Balances



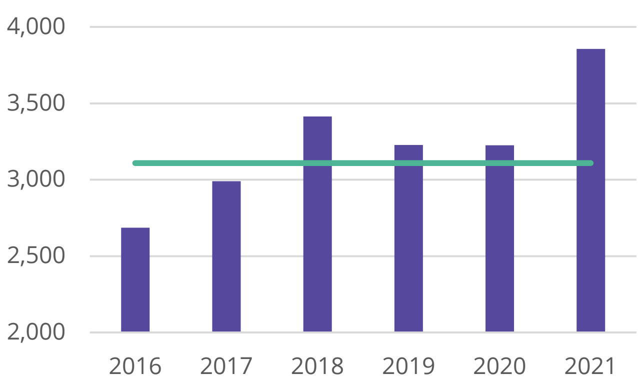
Source: Bank of Canada, World Bank, Avison Young

Mid market M&A activity remains robust

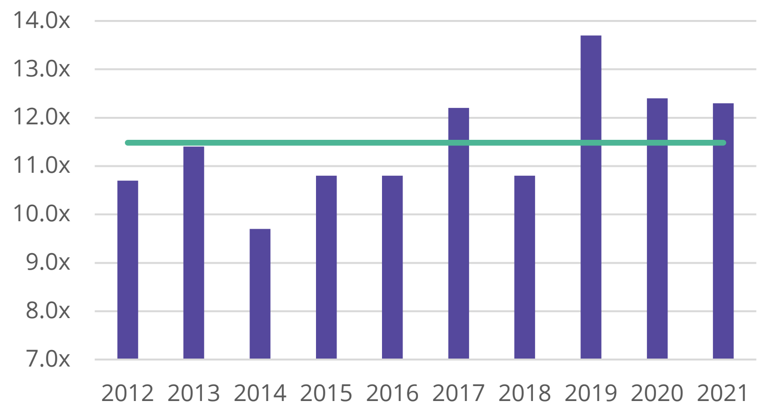
Recent updates

- Working hand in hand with sidelined capital (AKA dry powder) is a red hot M&A market that saw 2021 deliver a record number of total M&A transactions.
- Despite macro-economic headwinds, 2022 is setting up in a similar manner as private capital will look to deploy more capital on the back of another strong year of fundraising.
- Canadian mid-market M&A deal volume saw over 30% increase in 2021 (over 2020).
- 2021 EV/EBITDA sale metrics continued to be above average with the average purchase metric in excess of 12.0x.

Canadian Mid Market M&A Deal Volume



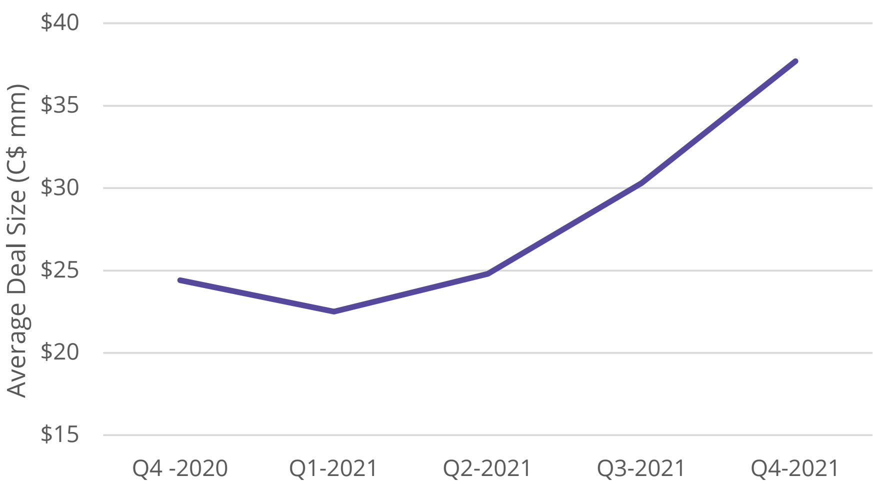
Canadian EV/EBITDA Sale Metrics



What to watch for

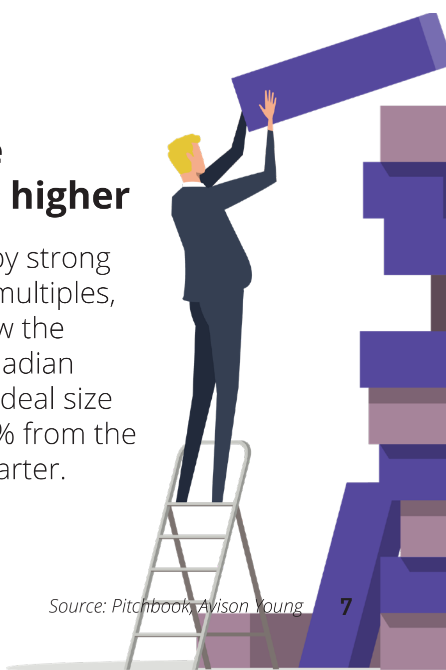
- Inflation pressures and the interest rate outlook will certainly have an impact on transactions for more inflation sensitive sectors.
- Likely to see an increase in deal activity in those sectors less sensitive to inflation pressures which include hard assets, commodities (mining and energy), REITs.
- A further increase in US based companies executing on cross border acquisitions in Canada.

Average Canadian Mid Market M&A Deal Size



Deal size marches higher

Supported by strong acquisition multiples, Q4/2021 saw the average Canadian mid-market deal size increase 25% from the previous quarter.



Source: Pitchbook, Avison Young

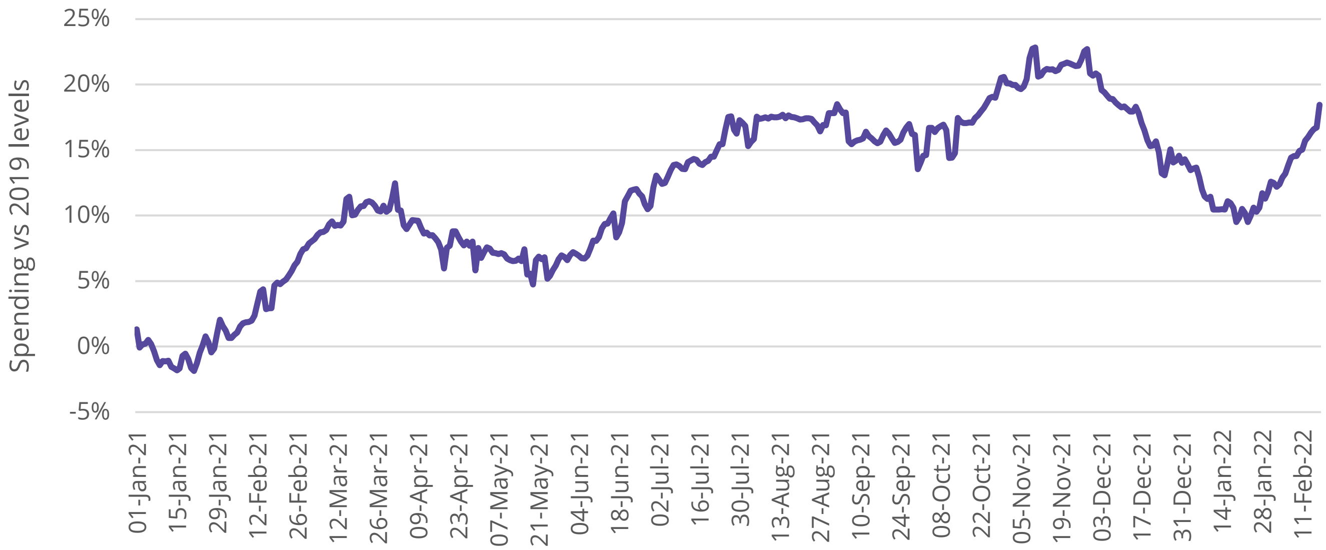
Tailwind | Consumer spending & savings

Canadian consumer spending

Recent updates

- Government support and a significant reduction of travel and service related spending has driven a material increase in Canadian consumer spending when compared to pre-pandemic levels (same time in 2019).
- Strong consumer demand will continue to support Canadian business which, as we have highlighted are managing against a number of headwinds.
- While overall consumer spending appears to be off from the peak seen in late 2021, travel and service spending remain compressed suggesting the underlying demand for goods remains extremely robust.

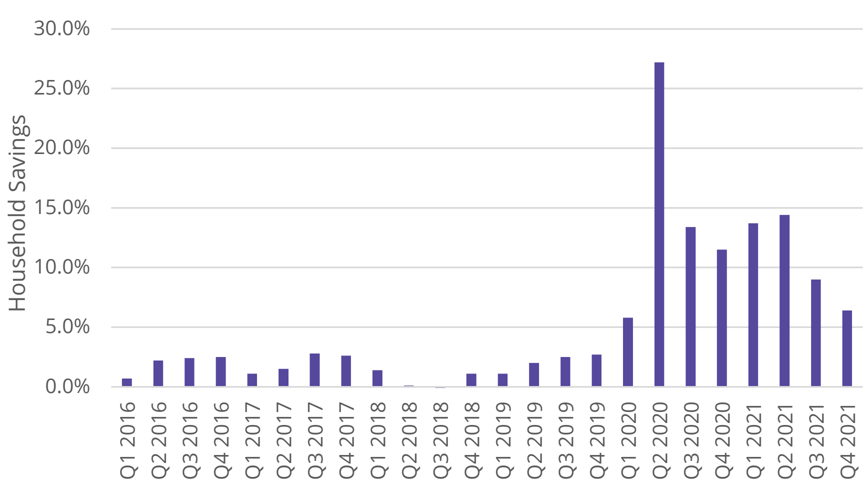
Canadian Credit Card Spending vs Same time in 2019



What to watch for

- We will be keeping an eye on overall spending patterns as consumers weigh the impacts of inflation on purchasing habits as we move through the year.
- As we see the recent wave of COVID subsiding, we expect to see a shift of spending habits towards travel (still down 60% from pre-COVID levels) and services.

Canadian Households Savings Rate



Canadian savings accounts well positioned

- Pre-COVID, Canadian households saved an average of 1.7% of household earnings.
- Ignoring the big jump in Q2/2020 household savings have increased to average 12.6%.
- While inflation will dampen spending capacity, it is good to see the average household continues to save.
- Q4/2021 saving data is starting to capture the impact of inflation on household savings rate which saw another decrease, we expect Q1/2022 to see a material reduction

Source: RBC Economics, Statistics Canada, Avison Young

Final thoughts - The best offence is a strong defense

As the saying goes, **"Cash is King"** and in the face of a number of headline risks, the best way to navigate the unknown is for businesses to be properly capitalized. Capitalization solutions can be wide ranging, from restructuring current debt obligations to raising equity, selling non core assets or bringing in a new partner. Regardless of the path chosen, the ultimate goal is to be best positioned to handle the inevitable bumps in the road and take advantage of market opportunities as they present themselves.

A proactive approach to risk mitigation can be the difference between businesses surviving or thriving. The Avison Young M&A Business Advisory team is positioned to help identify business risk, facilitate capital access or execute a business transition.

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