



Navigating distressed markets

How Canadian companies can navigate new realities: A perspective on Canada's slowing economy and sectoral disruption



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Foreword: Prepare for uncertainty

Although the Canadian economy has experienced ups and downs over the past decade, there have been far more ups than downs. Global economic disruption, however, may change that. Amid rapid technological advancements, international trade disputes, shifts in consumer buying habits, concerns about corporate ethics, and a revolution in the global energy markets, leading economists now believe that a recession may be looming.

While not every industry will be equally affected, certain sectors of the Canadian economy face particular risk—including oil and gas, automotive, Tier 2 financial lending, retail, and mining. Although this upheaval may present opportunity for some organizations, it poses a greater threat for many, particularly because this cycle appears different from previous ones. This time, for instance, the country is labouring under significant household, corporate, and government debt; the universe of Canadian corporate financial sponsors has changed; and several of the disruptors now assailing the market appear to be permanent.

Phil Reynolds
Restructuring leader

To help Canada's companies navigate this uncertain environment, Deloitte's special situations group prepared this paper that explores how new economic realities are affecting our country's key sectors and charts a path that key stakeholders can follow to protect and enhance corporate value. The course you plot for the future will unquestionably hinge on whether you are a business facing disruption, a lender, an investor, or an opportunist. Regardless of where you fall along the spectrum of disruption, you do have options. We hope you find this paper of value.



An economy in flux

Falling growth rates. US protectionism. Financial market volatility. When it comes to the signals of a slowdown, it seems the writing is on the wall.

Housing starts, a traditional indicator of economic well-being, declined in Canada at the end of 2018 for the first time in five years.¹ While it has since rebounded, the S&P/TSX Composite Index, which benchmarks the Canadian equity market, closed off the year with a 12-percent drop, its worst performance since 2008.² At the same time, consumer debt hit over \$2 trillion, which is roughly equivalent to Canada's annual economic output.³ And while the cap has since eased, the start of 2019 heralded a curtailment of 325,000 barrels of oil per day (Kbopd) in oil production in Alberta—a move bound to continue

rocking a national economy that derives almost 10 percent of its gross domestic product (GDP) from the energy sector.⁴ If oversupply extends beyond 2019 due to recent delays in the replacement of Enbridge's Line 3, these curtailments may continue as well.

Notably, Canada is not alone. In 2018, real GDP in China increased by only 6.6 percent year-over-year, its slowest rate of growth since 1990.⁵ Consumer spending also grew at its slowest pace in more than a decade. Given China's role as a growth engine for other countries, these statistics raise alarm bells. The

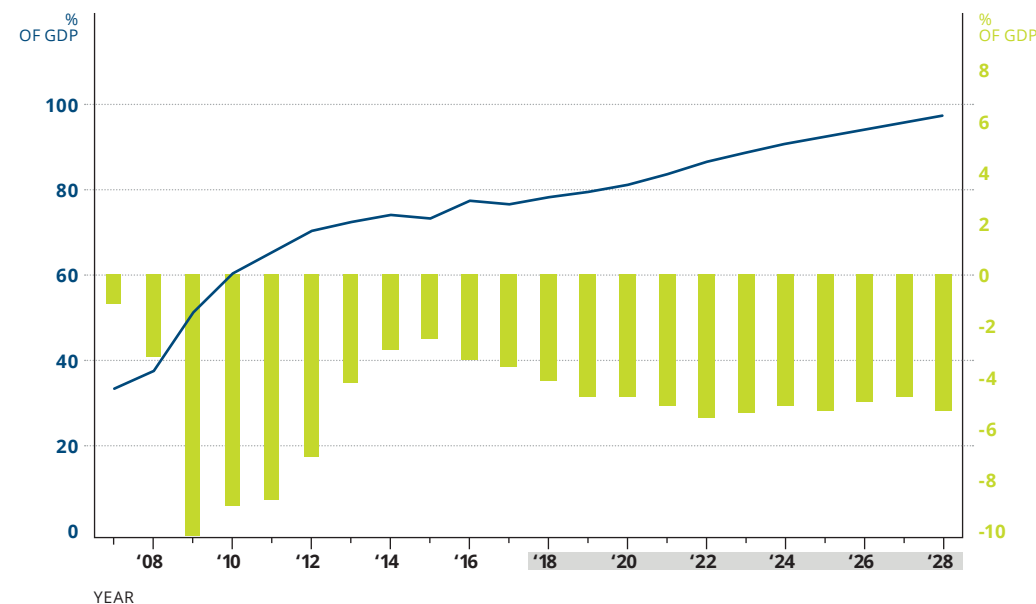
Eurozone economy also decelerated in the fourth quarter of 2018, due to sharp increases in energy prices, weak demand in China, and uncertainty about trading relationships with the United States. The US federal deficit is also spiralling, pushing the country's debt-to-GDP ratio to 96 percent (see Figure 1). Add in concerns over geopolitical uncertainty in the form of mounting tariffs, barriers to trade, and the United Kingdom's challenging exit from the European Union, and you get a recipe for a downturn—especially given that the recent boom has lasted longer than most.

Figure 1: US debt as a percentage of GDP

- Debt held by public (left side)
- Federal deficit (right side)
- Forecasted

Source: Haver Analytics; Congressional Budget Office

Note: The budget balance is negative because the US is running a deficit.



¹ National Bank of Canada, January 9, 2019. "Canada: Housing starts in 2018 declined for the first time in 5 years," by Kyle Dahms. Accessed at <https://www.nbc.ca/content/dam/bnc/en/rates-and-analysis/economic-analysis/economic-news-starts.pdf> on January 30, 2019.

² Financial Post, January 2, 2019. "Canadian stocks just suffered the worst year in a decade, but analysts say the future looks brighter," by Kristine Owram. Accessed at <https://business.financialpost.com/investing/canada-stocks-seen-reviving-after-worst-slump-in-decade> on January 30, 2019.

Some sectoral disruptions may be permanent

The maturity of the current economic cycle will likely yield different symptoms than prior slowdowns in light of the pervasive and concurrent influence of structural disruptors across a number of Canadian industries. Of course, not every sector will be affected in the same way, at the same time. As with every market cycle, some businesses will remain shielded and others will even benefit. The key to navigating these new economic realities is for leaders to understand where their company falls along that spectrum. That means Canada's organizations and around the world will need to develop tactics that allow them to identify potential vulnerabilities and ensure resilience. This is particularly critical for those segments of the economy that are facing material, and potentially unparalleled, disruptors that may alter their long-term fundamentals.

For instance, unlike prior cycles, many businesses are no longer dealing with traditional lenders and investors. Instead, they are working with completely different financial stakeholders, ones that may be new to dealing with distressed situations and/or that may be more inclined to enforce foreclosures and asset seizures on default than to negotiate amicable settlements.

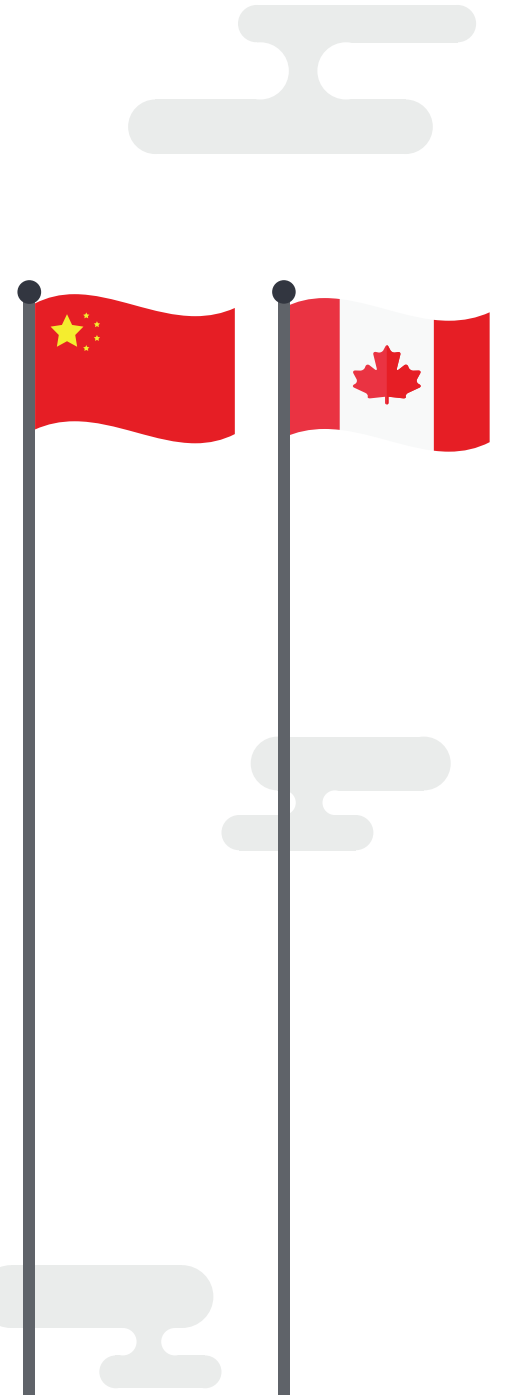
An easy recovery this time around is also in greater doubt. Significant, policy-level upheaval—such as rising US self-sufficiency and protectionism, deteriorating relations between Canada and China, an untested and seemingly unsettled North American trade agreement, and intrinsic changes in consumer sentiment and behaviour—are leaving indelible marks on the economic landscape and foreshadowing a potentially permanent alteration in market dynamics.

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³ Macleans, December 20, 2018. "Canada, it's time to pay off that debt," by Angela Wright. Accessed at <https://www.macleans.ca/economy/money-economy/canada-its-time-to-pay-off-that-debt/> on February 4, 2019.

⁴ Statistics Canada, January 30, 2019. "Gross domestic product (GDP) at basic prices, by industry, monthly, growth rates." Accessed at <https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610043402> on January 30, 2019.

⁵ CNBC, January 21, 2019. "China's economy grew 6.6% in 2018, the lowest pace in 28 years," by Huileng Tan. Accessed at <https://www.cnbc.com/2019/01/21/china-2018-gdp-china-reports-economic-growth-for-fourth-quarter-year.html> on March 5, 2019.



An industry view

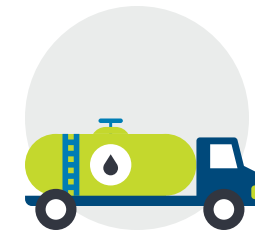
In a world characterized by transformative structural disruptions, some companies may struggle to emerge unscathed while others may be positioned to thrive. This will depend not only on the industry they play in but also on their relative position within that industry and/or their appetite for investment.



^{6,7,8,9} Industries of Special Interest. "Considering Market Opportunities as the Economy Slows, Segments Disrupt." December, 2018.

¹⁰ Government of Canada, 2018. "Canadian automotive industry." Accessed at <https://www.ic.gc.ca/eic/site/auto-auto.nsf/eng/home> on March 5, 2019.

The five key industries facing disruption are:



5,160 companies and 140,000 employees in Alberta⁶

Contributes 9% of Canada's GDP⁷

"Massive commodity price volatility and index differentials have taken a toll on Canadian businesses, and spurred recent changes to Alberta's legislative landscape. Among other things, commodity transport constraints are impairing an already difficult Canadian marketplace at a time when the United States is striving for energy self-sufficiency—and already producing 11+ million barrels of oil a day."

Andrew Botterill
National leader, Oil and Gas



Over 1,000 companies with 500,000 employees in Canada⁸

Contributes 15% of Canada's GDP⁹

"Fast-paced technological innovation combined with dwindling demand factors are calling the traditional original equipment manufacturer (OEM) model—and perhaps the overall Canadian transportation model—into question, promising rewards for those companies that can meet evolving consumer and public needs. Without question, OEMs are reallocating traditional budgets to make way for the new car. In Canada, roughly 700 OEM suppliers¹⁰ are in the middle (and in certain cases, at the forefront) of these changes."

Ovais Ghafur
Director, M&A Advisory

^{11,12} Industries of Special Interest. "Considering Market Opportunities as the Economy Slows, Segments Disrupt." December, 2018.

^{13,14} Retail Council of Canada, 2019. "Our Story." Accessed at <https://www.retailcouncil.org/who-we-are/our-story/> on April 16, 2019.

¹⁵ The Mining Association of Canada, 2019. "Mining Facts." Accessed at <http://mining.ca/resources/mining-facts> on April 16, 2019.



Estimated total market cap of \$8 billion¹¹

Assets under management of \$150 billion¹²

"An increasingly stringent regulatory environment is placing Tier 2 financial institutions under heightened scrutiny at a time when macroeconomic forces are affecting their credit exposure and profitability."

Andrew Luetchford
Partner, Capital Advisory



Canada's largest private sector employer¹³

Over 2 million employees in Canada¹⁴

"Caught between rising costs and a slow but relentless consumer shift toward online shopping, traditional retailers are increasingly feeling the squeeze."

Marty Weintraub
National leader, Retail Sector



426,000 direct workers and 208,000 indirect employees in Canada¹⁵

"While rising commodity prices and demand for battery minerals have injected new life into the sector, miners still face endemic challenges that may hamper their long-term growth prospects."

Robert Noronha
Partner, Transaction Services

Canada's evolving economy

2019 will be a year of economic transition

The Canadian economy has performed well over the last decade, perhaps better than most believe. Although the 2008/09 global financial crisis caused a deep recession, the Canadian economy recovered faster than most other advanced economies. Indeed, the level of economic output had recovered to its pre-recession peak before the end of 2010. Since then, the Canadian economy has been in the expansion phase of the business cycle.

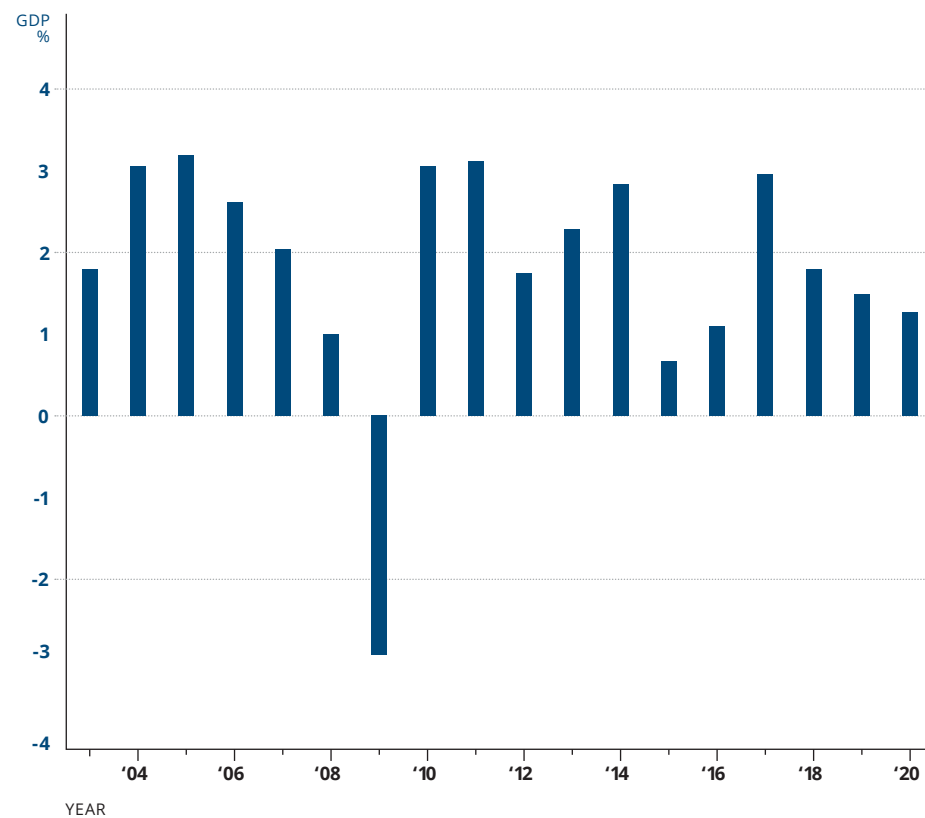
of the economy, highlighting how leveraged the economy is to trade. With global economic growth slowing, however, demand for Canadian exports and commodity prices will be tempered. The Canadian economy is expected to post an economic growth of close to 1.3 percent this year, which is a weak performance (see Figure 2).

There have been better years and worse years. For example, a commodity correction that hit commodity-leveraged provinces hard caused a national economic slowdown in 2015 and 2016. That was followed by robust, broad-based economic growth in 2017 and 2018, which created jobs and pushed the national unemployment rate down to a four-decade low.

With the arrival of 2019, however, there is clear evidence that economic growth has slowed. The Canadian economy stalled in the fourth quarter of last year, posting negligible annualized growth of only 0.4 percent: and creating a weak handoff to this year.

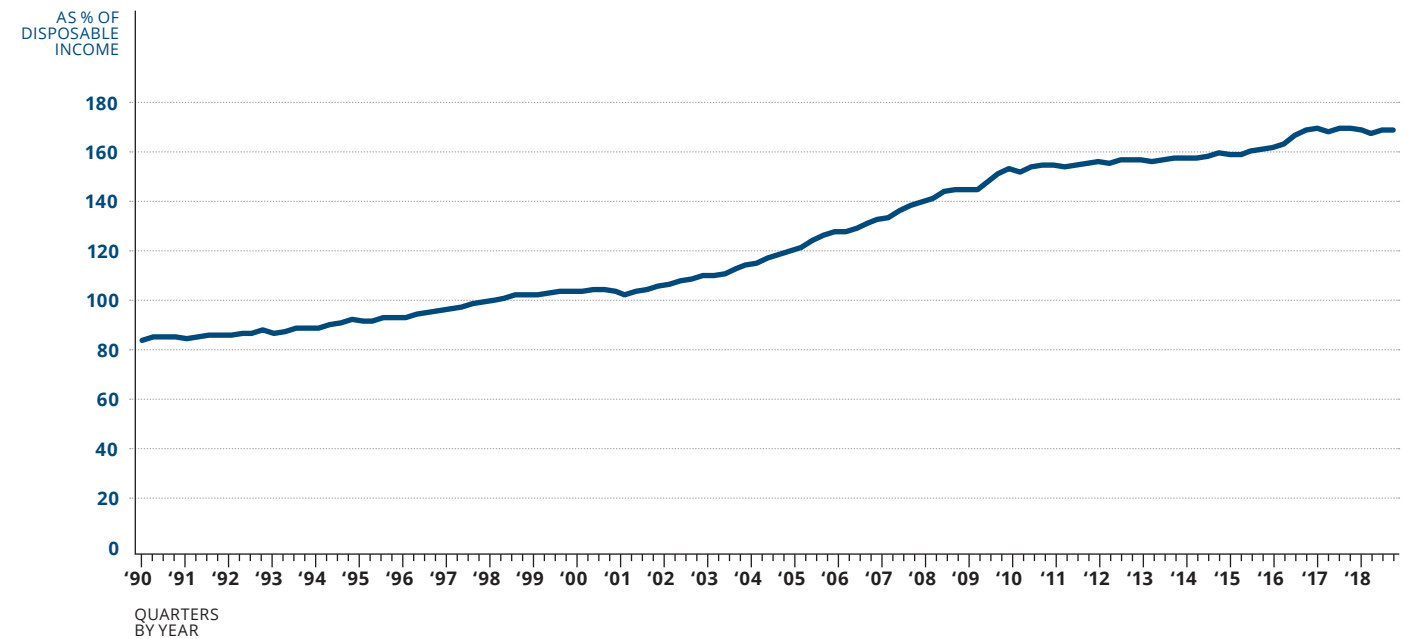
For too long, economic growth has been fuelled by consumer spending and real estate activity. Now, however, consumers have taken on considerable debt and real estate markets have cooled. This means exports and investment need to become bigger contributors to economic growth—and they will. Already, exports are roughly one-third of the total value

Figure 2: Canadian economic outlook



Source: Statistics Canada, Haver Analytics

Figure 3: Canadian household debt



Source: Statistics Canada, Haver Analytics

Emerging economic themes

Beyond the short-term outlook, businesses should be mindful of certain economic themes. First, it has been a decade since the last recession. The North American economy is in the late stages of a business cycle. We had recessions in the early 1970s, early 80s, early 90s, 2001, and 2008. Turning points happen about every eight to 10 years. At some point over the next three to five years, therefore, a recession is likely. This is a natural development, with the economy likely to contract for two to three quarters before recovering and returning to expansion. Businesses should think about how they will be affected and how they will respond to a turn in the business cycle.

The next recession will not be like the last; the Great Recession of 2008/09 was likely a once-in-a-century downturn. The depth and duration of the next one will be shaped by the imbalances that have been created in recent years. For example, a leading concern in Canada is household leverage, which climbed to 178 percent of disposable income in late 2018 (see Figure 3) and has seen debt service costs rise in response to Bank of Canada rate hikes. In the United States, there are some worries about the amount of corporate debt. Similarly, in Europe, bank and government balance sheets could be a source of weakness. There is also a question about the extent to which monetary and fiscal policy will

be able to provide stimulus in response to the next economic downturn, since central bank rates remain at low levels and many governments are already running significant deficits.

In addition to economic cycles, tectonic structural changes are also taking place. The technological revolution is disrupting business models and labour markets. While we still talk about national and regional economic trends, businesses increasingly operate in an integrated global economy. This has created fiercely competitive markets, eroding corporate pricing power and employee bargaining power.

The disruption creates challenges but also opportunities. The industrial leaderboard is changing fundamentally, with traditional goods-based industries like manufacturing and resources, while still growing, losing share of the Canadian economy to newer industries. Indeed, since the 1980s, the share of goods-producing industries in Canada has dropped by 20 percent while services have climbed by an equivalent amount (see Figure 4). Moreover, advanced services are a rising share of economic output and international trade. For example, trade in services increased 23 percent over the past five years, outstripping the 15-percent increase in trade of goods. This is happening at a time when an aging population and strong immigration are transforming consumer and labour markets.

The Canadian economy has repeatedly moved through business cycles and structural developments. The country's early economy, for instance, was dominated by resources and agriculture. After the Second World War, it shifted to branch-plant manufacturing. That engine has since given way to a well-diversified, increasingly knowledge-based and technology-driven economy. The upshot? The economy of 2019 is dramatically different than it was in the 1980s. And that of 2039 will be very different from what it is today. This makes it incumbent upon organizations to consider how they will ride out the economic cycle and how they will transform themselves into the success stories of the future.

“Challenges, but also opportunities, are surfacing that will fundamentally change the industrial leaderboard.”

Craig Alexander
Partner and Chief Economist
Economic Advisory, Deloitte

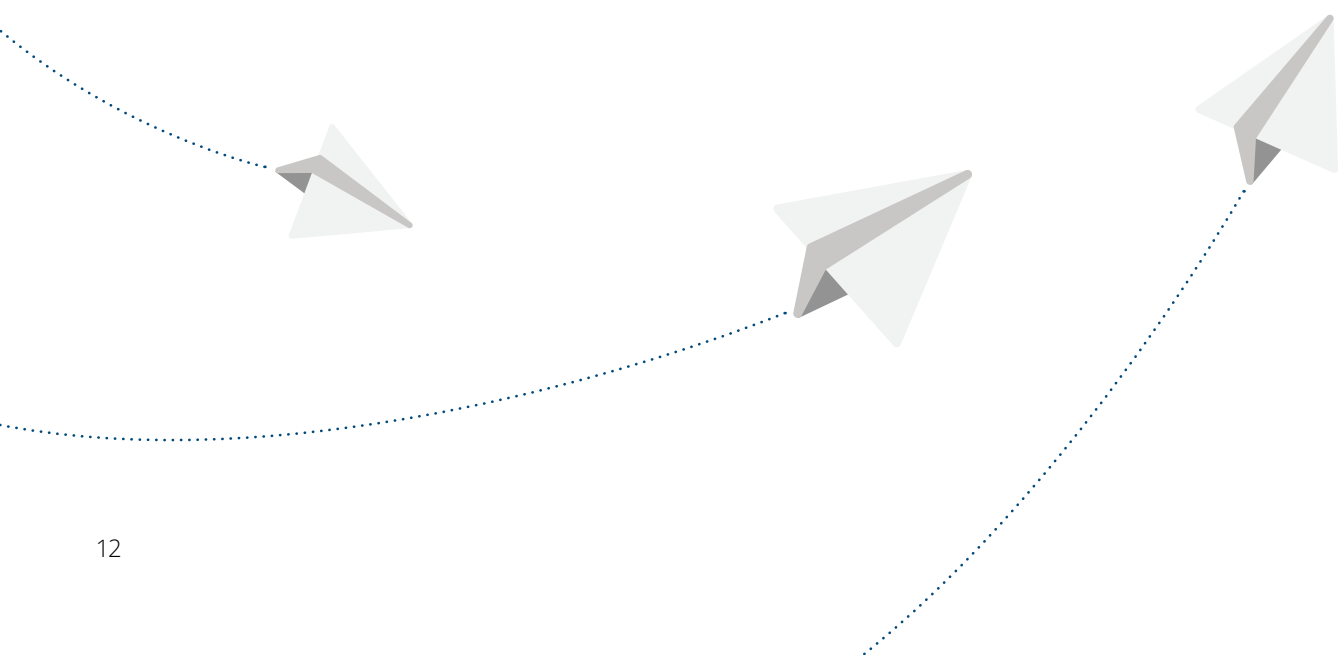
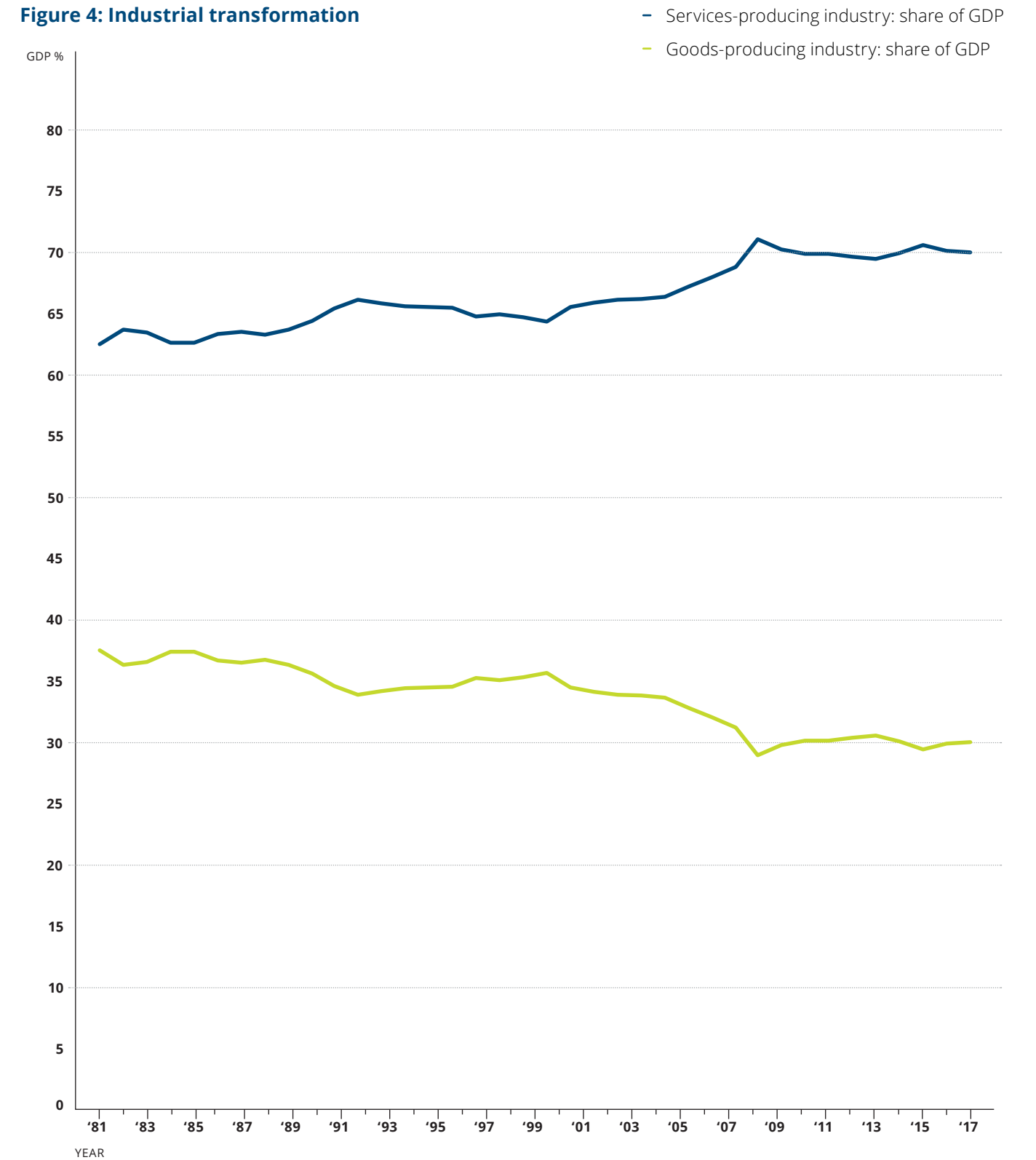


Figure 4: Industrial transformation



Source: Statistics Canada, Haver Analytics

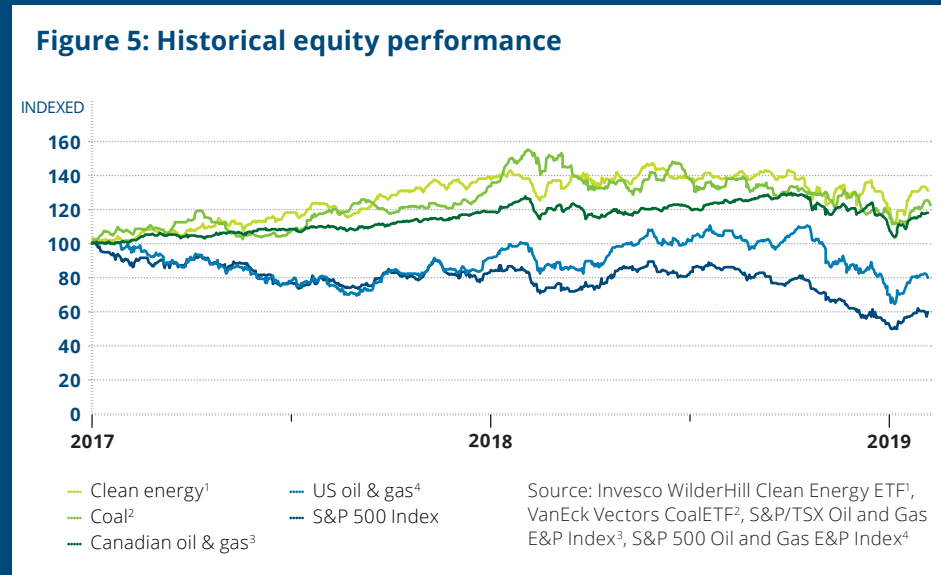
Industry disruption

Spotlight on energy

Canada's oil and gas sector is no stranger to volatility, but new and disruptive structural changes in recent months have upped the ante. The industry continues to experience what appear to be daily material events related to commodity transportation, production restrictions, environmental concerns, and legislative shifts, among other things.

Consider: between November 2018 and January 2019, the differential between Western Canada Select (WCS) and West Texas Intermediate (WTI) prices ranged from a US\$40/bbl high to a US\$10/bbl gap—a precipitous swing in such a short period. Meanwhile, capital budgets by upstream producers are being cut, most of which affect those in the oilfield services space; M&A activity has been sluggish amid a lack of access to capital; and pipeline woes are contributing to transport constraints and investment confidence.

With the industry in oversupply, a low-price environment will likely prevail for the foreseeable future. Producers will continue to adapt their cost structures in response, as only low-cost production will likely be developed. To reinstate the balance between oil supply and takeaway capacity, the Government of Alberta implemented a mandatory 8.7 percent production cut in January 2019. Notably, only larger producers are affected by this regulation, as operations producing less than 10,000 bbl/d are exempt. Service providers, including drilling companies, may find their fortunes sinking in the wake of this change. Conversely, junior oil producers, shielded from the mandatory



production cuts, may benefit from widening oil price differentials. All that said, production curtailments are only intended to be used until the end of the year to work through the oversupply. With the delay of Enbridge's Line 3 replacement from 2019 into 2020, there is concern that this tool will be required for longer.

Divergent tax approaches in Canada and the United States are exacerbating the challenge. While Canadian companies can deduct up to 30 percent of successful drilling costs per year, US producers can deduct 100 percent upfront, putting Canadian suppliers at a considerable competitive disadvantage. This comes at a time when US consumption of Canadian oil and gas is dropping off. Between 2008 and August

2018, US oil production doubled,¹⁶ displacing a significant amount of Canadian exports to its neighbour. This may herald yet another permanent change for Canada's energy sector.

At a more fundamental level, the industry is facing a consumer tide eager to move away from oil as a primary fuel and societal pressures making investment in hydrocarbons less acceptable. Unlike the other disruptors, which tend to wax and wane with evolving market forces, this shift in sentiment is likely both inexorable and permanent. The upshot is bound to be a rising incidence of industry consolidation, downsizing, restructuring, and insolvency—creating distressed buying opportunities for forward-looking investors.



Key market participant reactions

In these times of uncertainty, the reactions of market participants will fall along a spectrum depending on their strengths and vulnerabilities. Most, if not all, Canadian stakeholders (with the exception of the environmental authorities and regulators) are likely to experience negative consequences.



Producers will need to reduce spending and determine how to maintain or grow production more efficiently. They will experience stress until transport woes are resolved, which is unlikely before the end of 2019. WTI/WCS pricing differentials may drive liquidity challenges.



Lenders may cut the value of loans or set up cash reserves in response to price-related risks and concerns over regulatory restrictions on development. They may even take action to call in underperforming loans. Transparency of their collateral positions in light of recent court decisions about well-site reclamation responsibilities is now top of mind.



The **Alberta Energy Regulator (AER)**, in light of the recent Supreme Court of Canada Redwater decision that requires companies to pay for environmental cleanup even after insolvency, may demand higher liability management rating ratios, increased deposits/letters of credit, increased reporting requirements, and/or enhanced positioning as a stakeholder in stressed and distressed situations. This added scrutiny may put additional stress on the financial capacity of producers.



Oilfield service companies—including those providing well construction, road building, equipment, and production and completion services—will be hard-hit by contracting profit margins amid competition for volume and may have to reduce personnel to address a decline in industry spending. Drilling companies will see less activity due to the production curtailments and the lingering effects of elevated pricing differentials.



Private equity firms may be positioned to pick up low-value assets, but will likely only do so if Canada's investment outlook improves relative to the United States or if the subject assets can be relocated to more-profitable US jurisdictions.

In this environment, smaller producers that lack access to capital may find themselves vulnerable and in need of a transaction, a recapitalization, a restructuring, or all of the above. Without private equity or other forms of support, they will likely be unable to grow their assets, build a portfolio, or even survive. This may create opportunities for larger companies to acquire assets at bargain prices, if they are able to convince the public market about asset quality and healthy investor returns. It could also create opportunities for consolidators to bring together stressed assets, particularly in the services space.

¹⁶ Trading Economics. "United States Crude Oil Production." Accessed at <https://tradingeconomics.com/united-states/crude-oil-production> on February 6, 2019.

Industry disruption

Spotlight on automotive

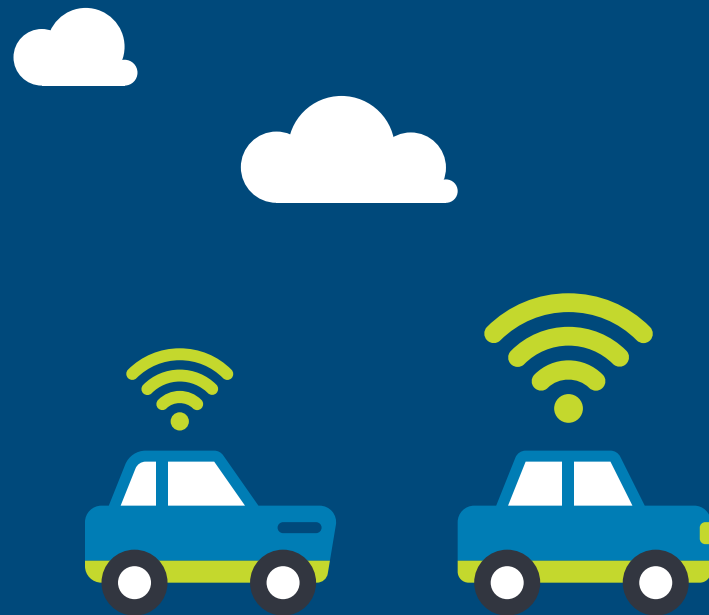
Technological innovation is a double-edged sword in the automotive sector, which accounts for roughly 10 percent of Canada's manufacturing GDP and 23 percent of manufacturing trade.¹⁷ While connected, autonomous, shared, and electric (CASE) vehicles are becoming increasingly feasible from a purely developmental perspective, they continue to face barriers around issues such as government regulation, infrastructure capacity, and fluctuations in consumer demand. The same is true for vehicle-to-vehicle (V2V) and vehicle-to-infrastructure (V2I) connectivity, which promises to let consumers enhance their driving experience by safely connecting to mobile phones, apps, and smart cars.

Despite the hurdles, there is little doubt these trends represent a permanent shift in the automotive sector. Companies committed to seizing a first-mover advantage understand the imperative to make big investments in this space—while also keeping their traditional business models afloat. Not surprisingly, some companies may crack under the pressure.

It doesn't help that vehicle markets around the world may be poised to contract. As both interest rates and consumer debt rises, vehicles are becoming less affordable, particularly given their relatively low rates of utilization and ever-higher pricing. At the same time, urbanization is increasing, with major centres getting denser. By 2050, approximately 68 percent of the world's population is expected to live in cities.¹⁸

Beyond fuelling the ride-hailing and shared-mobility economy, this is calling the traditional OEM model into question. Production volumes for internal combustion engine (ICE) vehicles are already falling, both in North America and internationally, with electric and hybrid vehicles picking up some of the slack. Consider that in 2012, electric engines accounted for only 2.3 percent of global production—this number is expected to jump to 9 percent in 2019 and 46.5 percent by 2026.

In an effort to respond to this materially changing panorama, many automotive companies have begun to rationalize their global footprint, evaluate their marketplace position, and enter into strategic partnerships—which may start looking more like acquisitions as the market turns.



¹⁷ Government of Canada, 2018. "Canadian automotive industry." Accessed at <https://www.ic.gc.ca/eic/site/auto-auto.nsf/eng/home> on March 5, 2019.

¹⁸ United Nations. "68% of the world population projected to live in urban areas by 2050, says UN," May 16, 2018. Accessed at <https://www.un.org/development/desa/en/news/population/2018-revision-of-world-urbanization-prospects.html> on February 5, 2019.

Key market participant reactions

In these times of uncertainty, the reactions of market participants will vary depending on their strengths and vulnerabilities. Which organizations are likely to win or lose?



OEMs will need to make major investments to rationalize their global footprint, help fund public-private collaborations to address infrastructure challenges, and gain a first-mover advantage in the CASE space—moves that will require them to materially reduce their cost structures.



Lenders that are exposed to component manufacturers that rely heavily on ICE, have limited capability with light-weighting technologies, and limited design and engineering capabilities may find themselves having discussions with their clients about the sustainability of their business, as volumes drop and future contracts dry up.



Suppliers will face intense pressure on margins as growth slows, hardware is commoditized, and investors begin demanding increases to shareholder value. As software becomes a differentiator, many existing competencies will be rendered obsolete and competition from new tech players will intensify. Component manufacturers that can't pivot from ICE to electric vehicle (EV) will likely see contraction. Sector consolidation is likely regardless, as electric-powered trains use far fewer parts than ICEs. Some estimates suggest EVs take less effort to build, making labour reductions more likely as well.

Industry disruption

Spotlight on Tier 2 financial institutions

As we enter the late stages of the business cycle, profitability in both retail and commercial banking is under pressure. This is due not only to regulatory pressures to hold more capital but also to increased spending across the sector as banks make bolder digital investments in an attempt to improve the customer experience. Many mid-sized and small banks are also upgrading their core technologies, so a credit downturn can only dampen profits.

Capital market volatility and the currently flat yield curve are also hurting large banks and, ultimately, borrowers, as banks pull back from long-term lending. At the same time, housing starts in Vancouver have already begun to fall and Toronto's market, which generally lags Vancouver's by eight to 12 months, has softened as well. Interest rates, which have gone up roughly five times in the past 18 months, are having an impact on home ownership. New regulatory stress tests that require homeowners to be more financially fit are also driving consumers to non-bank lenders, making it harder for Tier 2 financial institutions exposed to the residential market to capture and retain market share.

While market forces shift with business cycles, the move toward more stringent regulations marks a more permanent change. This is true not only on the lending side. Financial institution regulators are already considering a number of new measures, including the introduction

of stricter rules concerning deposits received online and higher capital positions for the banks.

High consumer debt rates in the Canadian market are also taking a toll on the industry, as it affects institutional ability to grow loan portfolios. It's a double whammy that not only reduces the frequency of new loans, but also makes existing loans riskier. This could affect the overall outlook for Tier 2 financial institutions that rely more heavily on local borrowers.

Notably, distress in the financial services sector often translates into distress in the economy at large, not only due to the disproportionate contribution of the sector to Canada's GDP but also because the economy will stagger if access to capital is restricted. A contraction in this space can consequently cause a downward ripple effect in other sectors as reduced access to funding prunes growth.



Key market participant reactions

In these times of uncertainty, the reactions of market participants will vary depending on their strengths and vulnerabilities. The industrial leaderboard will likely change, generating new opportunities and challenges. Which organizations are likely to win or lose?



Borrowers inevitably suffer disproportionate consequences from financial institution weakness. Beyond reduced access to funding, both individuals and corporations with revolving credit facilities could face serious cash flow challenges if they are overly reliant on a single lending institution.



Regulators have been introducing increasingly strict provisions to govern this industry, and are putting several Tier 2 financial institutions under the regulatory microscope.



Depositors present a unique challenge as well, as they could begin to withdraw funds if consumer sentiment toward the less-capitalized banks sours and funds are needed for purposes other than savings. This could draw the Tier 2 financial institutions into offering incentives to deposit—incentives that increase their cost of funds and further curtail their profitability.



Non-bank financial institutions, including private debt funds, could benefit from market weakness if they position themselves to acquire key distressed assets in advance. This will depend on their lending profiles, ability to offer low-cost funds, and funding sources. That said, non-prime lenders often see spikes in their credit losses early in a downturn.

Industry disruption

Spotlight on consumer/retail

Canada's retail sector is currently a \$580-billion industry, employing over two million people and with approximately 140,000 store locations.¹⁹ Yet, traditional retailers—who are caught between rising costs and a slow but relentless consumer shift toward online shopping—are feeling the squeeze. In addition to hikes in the minimum wage, the cost of retail space has been on the rise for years in major urban centres, putting a strain on margins. At the same time, retail sales are declining. As of November 2018, retail volumes had fallen five times in six months, advancing only 0.5 percent year-over-year—the third-smallest gain since the 2008 recession.²⁰

Increasingly, online retailers are the beneficiaries of this shift. In November 2018, retail e-commerce sales hit \$2.3 billion, accounting for 4.2 percent of the total retail trade.²¹ And while traditional sales volumes were falling, e-commerce volumes surged by 20.1 percent for the year.²² There is little doubt this digital revolution is permanent and will continue to evolve as innovations in social media, mobile technology, and advanced data analytics remain front and centre.

This disruption has had a significant impact on Canada's consumer and retail sectors over the last few years, with notable insolvency cases including Target Canada, Sears Canada, Payless ShoeSource Canada, Grafton-Fraser, Performance Sport, Golf Town Canada, and numerous other bricks-and-mortar retailers. Online players like Amazon have changed the game, putting retailers with a significant store footprint—as well as their suppliers, employees, and landlords—under growing pressure to alter their operating models. While bricks-and-mortar stores are not dead, they must be re-imagined to meet changing customer expectations.

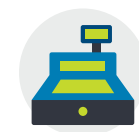


¹⁹ Retail Council of Canada, "Retail by the Numbers," November 2018, https://www.retailcouncil.org/wp-content/uploads/2019/01/RetailByTheNumbers_2019-01.pdf, accessed on March 5, 2019.

²⁰ National Bank of Canada, January 23, 2019. "Canada: Housing slowdown weighs on Retail sales in November," by Jocelyn Paquet. Accessed at <https://www.nbc.ca/content/dam/bnc/en/rates-and-analysis/economic-analysis/economic-news-retail-sales.pdf> on February 6, 2019.

Key market participant reactions

In these times of uncertainty, the reactions of market participants will vary depending on their strengths and vulnerabilities. Which organizations are likely to win or lose?



Traditional retailers that were founded before the digital retail revolution must continue to invest intelligently and rapidly to re-invent their business models and adapt to changes in the retail landscape—such as the adoption of new technologies and a shifting consumer mindset. Traditional retailers that effectively use data to understand their customers and take calculated risks to innovate will likely carve out an enviable competitive position.



Suppliers. The vendor landscape is also changing in response to current trends, mandating suppliers to work in a new ecosystem of partnerships while they continue to look for ways to sell direct to consumers, redirect trade marketing investments to maximize returns, and innovate product portfolios to combat niche companies focused on catering to evolving consumer tastes and preferences.



Digital natives. Unlike their traditional counterparts, newer entrants over the past decade or so (such as Amazon) may have had a head start on all things technology, but they face their own set of challenges as they contemplate how to offer experiences similar to those available from their more traditional competitors—those with developed (albeit shrinking) networks of physical stores. Stores provide a strategic lever that is costly and time-consuming to replicate.

²¹ Statistics Canada, January 23, 2019. "Retail trade, November 2018." Accessed at <https://www150.statcan.gc.ca/n1/daily-quotidien/190123/dq190123a-eng.pdf> on February 6, 2019.

²² Statistics Canada, January 23, 2019. "Retail trade, November 2018." Accessed at <https://www150.statcan.gc.ca/n1/daily-quotidien/190123/dq190123a-eng.pdf> on February 6, 2019.

Industry disruption

Spotlight on mining

After lagging for years, commodity prices have recently rebounded, putting mining companies on more solid footing than they've been for years. This is particularly true for miners with exposure to so-called battery minerals, which are surging in demand on the back of growth in the electric vehicle, electric storage, and nanotechnology industries.

Yet, while short-term prospects are positive for some, endemic industry challenges remain. The imposition of US tariffs on steel and aluminum has tightened already narrow margins in an industry that has yet to fully embrace the technological innovations that could spur lower production costs. At the same time, demand for commodities is declining due to slowing growth in China, a country that remains the world's largest consumer of most commodities.

At a more foundational level, the sector has fallen out of favour with investors. It's a trend that will likely be long-lasting, and could potentially be permanent. Several global technology companies, including Apple, have also committed to reducing their reliance on mined materials by recycling commodities instead, a transition that could one day entirely alter the mining industry's demand fundamentals.

Pressure is also coming from other sources. In some jurisdictions, including Canada, it can take a decade or more to secure mining permits and win a social licence to operate from local communities and other

key stakeholders. Competition for talent and capital introduces further complications, making it difficult for mining companies to innovate and grow.

Combined, these factors likely explain why most mining companies continue to struggle to gain access to traditional sources of capital. As a result, the debt burden of mining companies from non-traditional sources—including royalty streaming and offtake agreements—is on the rise.

Concurrently, consolidation in the form of M&As is on the uptick, particularly among Canada's gold producers. The future shape of the mining landscape is unclear: if capital continues to be directed to companies with existing and near-term cash flows, mid-sized players may decide to pursue single-asset consolidations, potentially leaving the smaller end of the market cash-starved.



Key market participant reactions

In these times of uncertainty, the reactions of market participants will vary depending on their strengths and vulnerabilities. Which organizations are likely to win or lose?



Producers with low cost bases and diversified players who produce more than one commodity will be best positioned to survive should demand decline. As in past cycles, producers may put marginal projects on care and maintenance, or increase output to reduce their average production costs. Companies unable to weather the storm may end up downsizing, consolidating, or engaging in insolvency proceedings.



Engineering, Procurement, Construction Managements (EPCMs) are currently operating in a tight labour market, which is expected to tighten even further in the medium term. Those without a proven record of safety and environmental compliance and/or a global reach will be at a disadvantage. Conversely, those capable of providing flexible financing options to capital-starved mid-sized miners may be able to win additional work.



Lenders have a long history of tightening the reins on lending to the mining sector when project economics decline. That said, certain funds may increase lending in distressed situations if it allows them to seize corporate assets in the event of a default.



Environmental authorities and energy regulators are on high alert following the Redwater decision. In essence, the Supreme Court of Canada decision confirmed that the liability of the "polluter pays" principle for environmental cleanup extends to the assets of an insolvency proceeding. This ruling, combined with a number of high-profile tailing dam accidents, has elevated environmental concerns. Environmental authorities may feel impelled to maintain their measured approach to granting approvals, slowing down mining projects as a result.

Questions to ask

Canadian companies, stakeholders, and investors should be asking themselves the following questions at the prospect of a slowing economy and sectoral disruption:

Companies



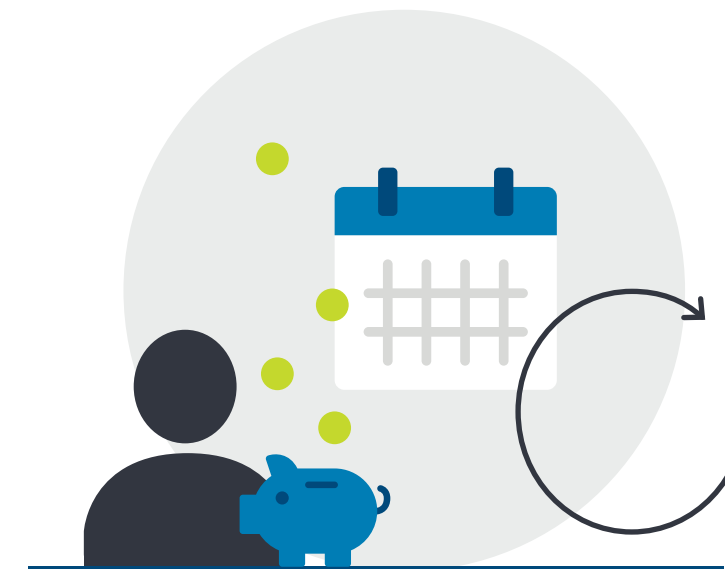
- 1 What are the key issues facing our business and the industry in which we compete?
- 2 Where does our organization sit in the competitive environment?
- 3 What will our operating landscape look like in the future?
- 4 Can we continue to generate meaningful returns for the foreseeable future?
- 5 Do we have the resources to fund our future state?
- 6 How can we deal with the near-term threats to our business model and corporate value?
- 7 How are our stakeholders faring and how do we monitor this (customers, suppliers, financiers, and employees)?
- 8 What opportunities are in the market that we can use to make our business better?
- 9 Who can we partner with to achieve our objectives?

Lenders



- 1 How healthy are our borrowers in sectors that are being disrupted? How do we measure it?
- 2 What actions do we need to take to gain full transparency over our collateral?
- 3 What will be the key factors affecting our clients in the near future and how can we help?

Investors/opportunists

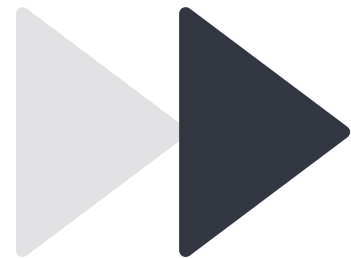


- 1 Where can we find value in disrupted sectors?
- 2 How do we determine what businesses warrant our next investment?
- 3 Is there a consolidation play that makes sense for us?
- 4 What does a distressed market playbook look like?

Responding to prevailing market conditions

Given the extent of the disruption affecting key industries, Canada's companies are at a crossroads. Some will now need to take steps to defend their position and corporate value. Others must assess how to enhance their value through some form of investment, transaction, or competitive bid. And there are those that will invariably need to exit their business in one way or another. Around these companies are financial stakeholders and opportunists: those interested in maximizing the value of their existing positions and looking for new investments capable of driving a solid return and adding value.

Organizations will need to consider which of the following paths to travel:



Protect value: defend against vulnerabilities

Protecting value in the midst of economic downturns and/or market disruption often starts with understanding the signals of stress and measuring their specific effects. Red flags include pervasive issues affecting short- and long-term demand, decreased business order-book volumes or revenue, reduced margins and profits, inability to attract talent, stakeholder weakness and unrest, working capital erosion, and other factors detrimental to corporate value and future prospects.

Businesses facing a fundamental step-change in their operating circumstances need to triage the root cause, assess its permanency, and establish whether they have the resources or other means to weather the storm. Access to capital or funding to absorb prolonged losses, make investments, or otherwise return to health will be at issue. In more serious situations, rapid asset sales, renegotiating terms with lenders, merger activity, material contract amendments, and balance sheet reorganizations may be required.

From an operating perspective, it's crucial to control costs and working capital in order to preserve liquidity and market position.

If business viability is in question or the enterprise is approaching insolvency, the game will change as the analysis takes on a life of its own. Various near-term issues will need to be addressed, including whether the business can adjust or reorganize in the short term, whether it needs to go through some form of informal insolvency process to restructure its affairs, or whether the business should be exited altogether. These situations can get particularly stressful for company boards, as they assess not only their duties to preserve value and to various stakeholders but, in some cases, their personal exposure to director and officer liabilities.



Preserve value: hold the middle ground

If the business is not at immediate risk of financial trouble, but there's not enough capital to take advantage of any opportunistic plays in current market conditions, many things can be done to enhance the overall chances of business prosperity. These include a sensitization of business plans for the new market environment, a monitoring program over corporate stakeholders, and a reaffirmation of the company's competitive position.

In addition, opportunistic plays —such as competitor acquisitions or mergers— may come to mind with changes in the market. These may result in



Create value: identify opportunistic plays

While economic distress creates difficulty for some, it opens the door for others. To benefit from the downturn and disruption, some groundwork needs to be done first. This begins by keeping a close eye on how the market may be affecting potential acquisition targets. Optimally, sufficient capital will be available to make an offer at the same time the targets most need access to funding.

Uncommon solutions for unexpected times

Canada's business leaders need to understand the downturn may be different this time. A range of structural changes that may permanently alter market dynamics has been bearing down, putting companies under relentless pressure to innovate or pivot if they hope to survive. Strategies that worked in the past may not be as effective this time around. To maximize outcomes, Canadian business leaders need to think and act differently.



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To prepare for the future, contact us today to set up a lab.

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