



TALKING POINTS

Responses of Canadian
Middle Enterprises to CAD
Appreciation

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TALKING Points

Responses of Canadian Middle Enterprises to CAD Appreciation

- The sharp and rapid appreciation of the Canadian dollar against the U.S. dollar has exacted a major toll on Canadian exporters, whose foremost market is the United States
- Recent shifts in the CAD/USD exchange rate reflect both the impact of Canada's commodity boom and the slowdown in the U.S. economy
- CAD appreciation has generated a windfall for Canadian producers of petroleum, coal, and primary metals, whose global prices have soared since the early 2000s
- But the CAD's ascent has seriously damaged Canadian manufacturers dependent on the U.S. market, particularly auto parts suppliers linked to the biggest three car companies and pulp/paper exporters tied to the flagging American housing market
- The earlier, prolonged period of CAD weakness lulled many Canadian companies into a false sense of security, leaving them unprepared to cope with the competitive repercussions of the recent currency appreciation
- The increased purchasing power resulting from CAD appreciation enables Canadian companies to acquire advanced technology from the United States, but few middle enterprises are exploiting this opportunity
- Similarly, few mid-sized Canadian companies are fully utilizing the risk management instruments available to them (including natural hedging and financial derivatives) to lower their exposure to CAD appreciation
- Some Canadian exporters are responding to shifts in the CAD/USD exchange rate by diversifying to non-U.S. markets, including Asia and the European Union
- The long-term competitiveness of Canadian middle enterprises depends on operational performance improvement, technological innovation, and improved human capital

Responses of Canadian Middle Enterprises to CAD Appreciation

The Canadian dollar / U.S. dollar exchange rate is an enormously important factor in the performance of the Canadian economy. There are few Canadian enterprises that do not feel the effects of currency shifts.

The centrality of the United States as a market for Canadian exporters amplifies the impact of CAD appreciation. Canada exported over \$350 billion of merchandise to the United States in 2007. As the CAD appreciates, Canadian exports become more expensive for American buyers and thus less competitive in the gigantic U.S. market.

It is not only the appreciation of the dollar that affects Canadian companies, but also the rate of its ascent. At USD1.00, Canada's currency has appreciated in value by 60% against its American counterpart since January 2002. The CAD's rapid ascent has given Canadian companies little time to prepare for the resultant impact on exports to the United States.

Factors Driving CAD Appreciation

The Canadian dollar's appreciation stems from four interrelated factors:

- Increased global demand and higher prices for Canadian commodities and energy exports
- Strong economic growth in western Canada, which has boosted inflation and kept Canadian interest rates relatively high
- Weakening demand in U.S. housing and consumer markets
- The depreciation of the American dollar against major freely floating currencies, which has been aggravated by the problems and uncertainty in U.S. credit markets

Industry Effects

Some Canadian industries are benefiting from CAD appreciation. The "loonie" (named for the Canadian bird depicted on the one-dollar coin) began to take off in late 2002, just as global commodity prices started their historic climb. The commodity price boom has generated a large windfall for key Canadian industries: Between 2003 and 2007, prices of petroleum, coal, and primary metals have soared, boosting revenues of Canadian suppliers of those products.

The overall gain in Canadian exports in 2007 was driven by commodities (notably industrial goods, agriculture and energy), which accounted for half of exports that year. Prices for these goods remain buoyant on world markets, as rising demand from emerging nations more than offsets economic weakness in the United States. Canadian exporters have responded by shifting away from the slumping U.S. market; while exports to the United States fell 2% in each of the last two years, overseas shipments rose 13% in 2006 and 16% in 2007.

However, CAD appreciation has exacted a serious toll on Canadian manufacturers. According to CIBC (Canadian Imperial Bank of Commerce), over 300,000 jobs have been lost in the manufacturing sector during the past five years. CIBC is forecasting another 200,000 job losses in the industry by the end of the decade - most of which will be concentrated in Canada's most populous province of Ontario.

Canadian auto parts manufacturers are particularly hard hit, as the 'big three' North American car companies represent their largest customers. The 'big three' are themselves dealing with decreased sales, plant closures and layoffs. The woes of the U.S. auto sector immediately trickle down to their Canadian suppliers. Many Canadian auto parts manufacturers signed contracts with U.S. customers when the CAD was trading under 90 cents USD. With the two currencies now trading near parity, those Canadian vendors find themselves in a precarious position.

Canada's pulp and paper industry is also reeling under the dual impact of CAD appreciation and the U.S. housing crisis.

The Artificial Price Advantage

Canadian exporters generally prefer a weak CAD. But a sagging currency can lull undisciplined companies into a false sense of capability and competitiveness. Nothing makes an uncompetitive export business look better than a currency trading well below its proper value for an extended period of time. The many years that the CAD was in the 62 –70 cent range created a sense of complacency that left many Canadian export manufacturers ill-equipped to compete with a Looney trading over 75 cents U.S.

Canada's Minister of Finance has encouraged manufacturers to leverage the strong Canadian dollar to purchase new technology from the U.S., thereby reducing operating costs and increasing productivity. Although few would disagree with this strategy over the long term, Canadian manufacturers are struggling with short-term solutions to deal with the tough times. In a survey taken by the Canadian Institute of Chartered Accountants in January 2008, only 20% of the respondents have taken advantage of CAD appreciation to purchase capital goods at a decreased cost.

Countering CAD Appreciation

Natural hedging is an effective means of countering the effects of the rising Canadian dollar. By aligning their USD sales with USD purchases of raw materials and inputs, Canadian companies can reduce their exposure to currency shifts. However, a survey of the audit partners at RSM Richter reveals that very few mid-sized clients are changing their suppliers or customers to create natural currency hedges.

Larger mid-sized companies may employ financial derivatives to mitigate their foreign exchange risks: forward contracts, options, currency swaps. But again, a poll of RSM Richter audit partners indicates that mid-sized companies do not make extensive use of such instruments to reduce their currency exposures.

Another remedy to shifts in the CAD/USD exchange rate is reducing trade dependence on the United States. In 2000, the U.S. captured 83.6% of Canadian exports. By 2007, the U.S. export share had fallen to 76.4%.

Meanwhile, Canada's exports to the rest of the world are growing. Between 2001 and 2006, Canadian exports to the United Kingdom increased by 33%. During the same period, exports to other members of the European Union grew by 14%. In Asia, Japan remains Canada's top export market. China is a close second as an export destination, and continues to be Canada's top Asian importer.

In addition to hedging and trade diversification, Canadian companies grappling with CAD appreciation must pursue operational improvements, supply chain efficiencies, and outsourcing strategies. The cost savings resulting from these measures permit increased investment in new technologies, innovation, skills training, and other measures essential to sustain Canada's international competitiveness.

The author is Joel Cohen, Executive Partner, RSM Richter, the Canadian member firm of RSM International.

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Biography

Joel Cohen



Joel Cohen is an Executive Partner in the Assurance group at RSM Richter, and is a member of the firm's Executive Committee. Joel brings a depth of experience gained through more than twenty-five years as a partner in the firm and as a hands-on business advisor to a wide variety of entrepreneurial and public company clients.

Joel has extensive experience in audit, advisory services and income tax planning. He has been involved in audit design, the review of audit findings, audit and accounting research, financial statement preparation, presentations and disclosure.

Joel specializes in providing consulting services including strategic business advice, acquisition and sale of business, estate planning, refinancing and reorganization and special accounting and financial projects.

In addition to his direct client-handling responsibilities, Joel serves as the Managing Partner of the Toronto Assurance and Tax practice.

Joel is a member of the Canadian Institute of Chartered Accountants. He has previously sat on various charitable and professional committees and is currently a member of the Board of Directors of the Muskoka Lakes Association and a member of the Bloorview MacMillan Centre Finance and Audit Committee.

Professional Designations and Education

- Chartered Accountant, Alberta (2003), Ontario (1970) and Quebec (1970)
- Bachelor of Commerce, McGill University, 1967

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