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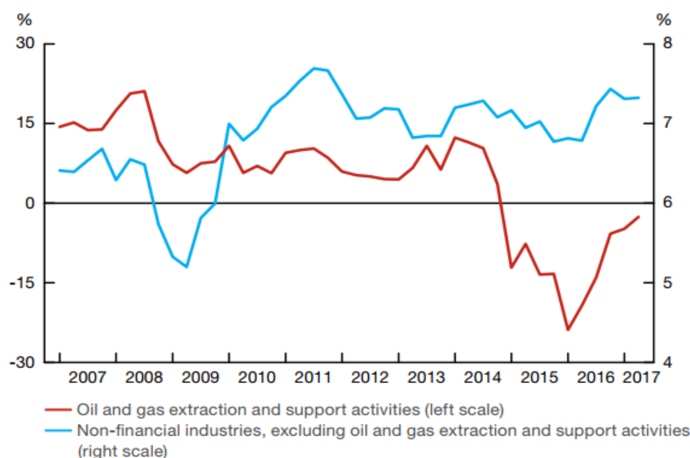
Canadian Profits: Challenges, Lessons and Opportunities

Recent GDP figures in Canada have been sound and Canadian corporate profit margins have trended positively over the past year. In addition, when compared to the US market, Canadian valuation comparisons on a forward earnings basis point to a relative discount. While these are positive data points, it is helpful to look at the context of the past economic cycle for additional information. The historic Canadian profitability chart below provides some insights into present challenges, past lessons and prospective considerations for a key investment return factor - changes in earnings.



Source: Statistics Canada and Bank of Canada calculations
Last observation: 2017 Q2

Present Challenge: Canadian non-energy firms are posting above average profits (blue line)

As seen above, profitability is above average for non-energy related firms. While this is attractive, it also poses a challenge for future investment returns. Presently, many firms are being valued on the continuation of peak profit margins. While teams can always point to company specific growth, in reality, it does seem that growth opportunities are less abundant and non-energy profits are more susceptible to mean reversion today. When coupling heightened profit levels with above average valuations in the non-resource space, return profiles are increasingly dependent on a stable or improving earnings environment.

Past Lessons: Profitability of oil and gas related firms (red line)

The concerns on investing in an above average part of the earnings cycle have been accentuated from a real lesson learned at QV over these past few years. The steep decline in profitability of energy firms since 2014 is a reminder that what we don't know can change our perspective on what is value. As a result, deeper investigation into whether historic profit growth is firm specific or the rising tide of an industry, is a key question to ponder. This is no guarantee of mitigating all losses, but it helps guide thoughtful decision making such as portfolio weightings or surfacing additional downside risks.

Looking back, profit margins in the energy space had trended positively from 2012 to 2014. Valuations on cash flow and earnings measures looked reasonable relative to the benchmark and historical levels. However since then, firm profitability from 2014 on has been devastated. As a result, firms today are looking to survive rather than post outsized growth.

Prospective Opportunities and Considerations:

In this current Canadian earning cycle, revenue growth seems like it will be a modest contributor going forward as consumer spending is tempered by elevated debt levels. Further, contemplating the earnings growth outlook for Canadian enterprises, it seems telling the two largest TSX sectors, Financials and Energy, seem more focussed than ever on efficiency and cost control. Given what could be a slower period for profit growth, our focus remains on finding businesses that can survive good and tough periods. Despite the devastation in the energy space's profitability, there are opportunities to own related businesses that have diversified and grown through this downturn. The enhanced discipline on costs could provide support for mean reversion and an earning cycle recovery. Ultimately, since these cycles are unpredictable, we continue to be focussed on looking for and owning defendable franchises, which provide a case for value in above and below average profitability scenarios.

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