

FRIDAY, OCTOBER 15, 2004

The Hollowing Out of Corporate Canada

By Eric Reguly

Is Toronto's Bay Street corridor in danger of looking like downtown Buffalo?

Gord Nixon, the CEO of Royal Bank is by nature a free trader. His company, Canada's largest by market value, has bought about US\$6-billion of banks, insurers and brokerages in the United States in the past three years and has every intention of continuing the spending spree. Royal, as a result, has evolved into a truly international player and it won't be long before the Canadian operations are smaller than the foreign ones.

This is what any city, any country cherishes—big, thriving head offices anchoring vast empires. Head offices provide challenging, high-paying jobs, which in turn create other jobs, from accountants and lawyers to ad designers and chefs. They support the arts and pay taxes that buy social services. They keep talented university grads from fleeing. It is no exaggeration to say that Royal and the other Big Five banks keep downtown Toronto from looking like Buffalo, N.Y., on a bad night.

Yet Nixon would be the first to admit that he would be out of a job if the banks were not takeover proof. "If the banks didn't have ownership restrictions, they'd all be gone," he says. That wouldn't be a lot of fun, of course, for him or any of his employees. So is he really a free trader?

Officially, yes; privately, he'd have to think about it. How Canadian. Minus ownership restrictions, he says, the Canadian banks would disappear into the maws of any of the dozens of far larger financial players, among them Citigroup, JP MorganChase and HSBC. The new owners would likely run the Canadian banks by remote control from enormous head offices and information technology centres outside the country. The Canadian banks, in short, would be hollowed out, top jobs would disappear and urban vitality would suffer.

The scenario is not fantasy. Eventually, Canada, a paid-up member of NAFTA and the World Trade Organization, and America's No. 1 ally and trading partner, will be forced to dilute or eliminate the foreign control restrictions on financial services companies and the other protected industries, among them airlines, media and telecommunications. When that happens, what will be their fate? Based on history, many, if not most, will disappear into foreign hands, bestowing branch plant status on another slew of industries. A few of the biggest financial players, notably Royal and Manulife Financial, are well aware of the trend and are bulking up in defence. They are gambling that enormous size at home and abroad, combined with highly efficient operations, might protect them from takeover when the ownership restrictions slip away. They may not be right, but doing nothing would certainly be a death sentence.

The hollowing out of Corporate Canada has become a divisive, headline grabbing issue. The believers and non-believers cite a bewildering array of statistics to argue their cases. The non-believers, among them Toronto Stock Exchange CEO Barbara Stymiest, cite figures from Crosbie & Co., a Toronto investment boutique that tracks takeovers. She has noted that, in the last seven years, Canadian companies bought 384 more American companies than the other way around. "It looks more like the bulking up of corporate Canada," she has said. Stymiest also notes that the trading volume of Canadian inter-listed companies - companies listed on the TSX and one of the three big U.S. exchanges - is migrating back to the TSX. In other words, hollowing out is a myth.

Now let's take figures that paint an entirely different picture.

Statistics provided by Industry Canada and the U.S. Department of Commerce say that, between 1995 and 2001, American companies took over 3,008 companies in Canada, while Canadian companies bought 697 American companies. The Investment Review Division of Industry Canada says that, in the first half of 2002, there were 223 foreign takeovers worth C\$37.3-billion. By Crosbie & Co.'s calculations, the foreign takeovers in the same period were worth only C\$6.9-billion. Which stats are more reliable? According to Mel Hurtig, the author of "The Vanishing Country," to be published in October, the official government figures tell the truer story. The book, Hurtig says from Edmonton, "is about the tragic sell-out of Canada."

Certainly, Nixon would support the government figures. By the Royal Bank's own calculation, 62 of the largest companies, representing more than one-quarter of the public float of the TSX index of 300 companies, have vanished through mergers or acquisitions since 2000. If that's not hollowing out, what is?

Let's assume, then, that the hollowing out trend is real, even though the stock market slaughter has bounced the issue off the headlines in recent months. Why does it matter and what can be done about it?

It matters because it's not in the best interests of Canada's leading cities to turn into Milwaukeees, that is, secondary, branch-plant centres. Look what happened to Montreal. Before the Parti Quebecois got elected in 1976, Montreal was the undisputed economic, financial and cultural capital of Canada. Less than a decade later, after the exodus of Sun Life and dozens of other A- and B-list companies, Toronto had assumed that title. Is Toronto the next Montreal? Probably.

As globalization continues apace, New York, Boston, Atlanta, Dallas and San Francisco could do to Toronto what Toronto did to Montreal. The great sucking sound you hear is the sound of professional careers moving south. When this happens, spin-off jobs disappear as well, and it's not too long before a city's tax base erodes. Cities that lose their largest employers are cities in slow-motion suicide.

The hollowing out skeptics don't deny that head offices are vanishing. They argue that it's inevitable in an open market. A new C.D. Howe Institute report called "Preserving Control" concludes, in effect, that Canadians should relax because Bank of Canada research "indicates that the total value of Canadian firms taken over by foreigners is almost the same as the total value of foreign firms taken over by Canadians." This may or may not be the case, but it misses the point. To retain some sort of balance, Canadian companies would have to acquire \$10 worth of American companies for every \$1 going the other way. Indeed, Hurtig's book will show that

foreigners control some 30 per cent of Canadian corporate revenues. In the U.S., foreigners control a mere 6.4 per cent of corporate revenues.

The hollowing out trend will go in fits and starts—the bear market has substantially reduced the takeover pace—but the longrange outlook doesn't look favourable for Canada. What can be done to slow it down, even reverse it? There is no easy answer. Federal governments, no matter what their political stripe, will likely keep some sort of ownership restrictions on “strategic” industries, with financial services at the top of the list. Making Canada more competitive,

Nixon's solution, is probably the best idea. Among other things, it means keeping tax rates competitive, ditching the onerous capital tax, eliminating inter-provincial trade barriers and ramping up research and development expenditures (Canada's R&D spending is among the lowest in the world). It also means convincing Ottawa not to act simply as a money-transfer point, sucking tax dollars out of Toronto and Calgary and pumping them into loser industries and have-not provinces. If the world discovers that Canada is a superb place to invest, it will attract and keep head offices. This process could take decades. In the meantime, watch Canada's cities get more hollow before they fill up again.

MAJOR TAKEOVERS SINCE 1995

Value (\$bln) Canadian Firm Taken Over by Foreign Firm

\$41.7	Seagram Co. Ltd	by Vivendi SA
\$10.8	Newbridge Networks Corp	by Alcatel SA
\$6.7	Gulf Canada Resources Ltd	by Conoco Inc
\$5.9	BioChem Pharma Inc	by Shire Pharmaceuticals Group PLC
\$5.5	Westcoast Energy Inc	by Duke Energy Corp
\$5.3	Anderson Exploration Ltd	by Devon Energy Corp
\$5.1	Bell Canada (20% stake)	by Ameritech Corp
\$4.1	C-MAC Industries	by Solectron Corp
\$3.7	Norcen Energy Resources Ltd	by Union Pacific Resources Group Inc
\$3.6	Newcourt Credit Group Inc	by CIT Group Inc
\$3.6	MacMillan Bloedel Ltd	by Weyerhaeuser Co
\$3.3	Canadian Hunter Exploration Ltd	by Burlington Resources Inc
\$2.9	Celanese Corporation	by Hoechst AG
\$2.7	John Labatt Ltd	by Interbrew SA
\$2.7	Trimark Financial Corp	by Amvescap PLC
\$2.6	Poco Petroleum Ltd	by Burlington Resources Inc
\$2.6	Shoppers Drug Mart Ltd	by Kohlberg Kravis Roberts & Co
\$2.2	Laidlaw Inc	by Allied Waste Industries Inc.
\$2.0	Hemlo Gold Mines Inc	by Battle Mountain Gold Co
\$1.8	Avenor Inc	by Bowater Inc
\$1.7	Rio Algom Ltd	by Billiton PLC
\$1.7	Solect Technology Group Inc	by Amdocs Ltd
\$1.4	Janna Systems Inc	by Siebel Systems Inc
\$1.4	Rogers Cantel Mobile	by British Telecom (33% stake) PLC/AT&T Corp
\$1.4	St. Laurent Paperboard Inc	by Smurfit-Stone