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Corporate Research Battered But Holding Steady

THE HEADY DAYS OF ANNUAL DOUBLE-DIGIT INCREASES IN CORPORATE R&D SPENDING ARE OVER, at least for the foreseeable future. Does this signal a permanent new reality and a potential erosion of Canadian industry's long-term competitiveness that we should be concerned about? Or are companies merely pausing to regroup in light of current economic circumstances?

For the past few years companies on the Top 100 Corporate R&D Spenders List posted impressive gains in research spending: Fiscal 2001 (up 23.3%) and Fiscal 2000 (up 26.0%). (These figures set aside Nortel Networks' results, as Nortel's R&D spending is so large it overwhelms underlying trends). Of course in those intoxicating years corporate revenues and profits were up, and capital markets were eager to fund companies that were investing in new products and services.

This year's result, for Fiscal 2002, was a gain of 6.5% — far more muted than in the past, but under the circumstances quite respectable. (After all, what investor would not have been satisfied with a 6.5% increase in their portfolio last year?)

What is notable about this year's 6.5% R&D spending increase is that it surpassed the Top 100 companies' 5.4% growth in total revenue — quite an achievement in a tough market. Rather than overreact and make deep cuts to their investment in research, many companies opted to wait out the revenue downturn. Overall, they did pare their research spending, but to a lesser extent than their revenues declined. At the same time many firms continued to grow their R&D activities. Both groups of firms recognized that R&D is their long-term life-line, and made efforts to insulate their research from what they hope will be a short-term fall in revenue.

There is no better example than Canada's R&D leader, Nortel. Although its revenue plummeted by 38.8% in Fiscal 2002, Nortel's management and directors opted to cut research spending by only 29.8%. As a result, Nortel's research intensity (R&D as a percent of revenue) jumped to 21.1%, which is extremely high for an established company in this industry sector (or any industry sector for that matter). Assuming that Telecom equipment spending will recover in the next couple of years, Nortel will be well-positioned with new and improved product offerings. What about other industries and firms?

As for the remaining Top 100 firms, 65 increased their R&D spending last year against 33 firms who cut back (one company's R&D remained the same). Not a bad result in a soft economy. Even in this tough business environment a number of industry sectors managed to improve their R&D results, though others did not fare as well. For example, while Top 100 companies in the Electronic parts and components sector suffered a -5.5% decline in total R&D spending, those in the fast-growing Pharmaceuticals/biotechnology sector posted a 17.4% spending gain.

Canada's economy — and the number of industrial sectors engaged in research — is more diverse than a decade ago, and thus better able to withstand slowdowns. We think that companies' reluctance to cut their R&D last year also signals a maturation of corporate leadership. Clearly, the innovation message is sinking in among company leaders. They are apparently less willing to trade off quarterly returns against their companies' long-term prospects than they would have been a decade ago. Apparently, investors are also more willing to take a long-term view.

These developments bode well for the federal government's innovation strategy. The strategy, launched last year, aims to put Canada into 5th place (from around 15th place today) in worldwide research spending, by the end of the decade. It is an ambitious target that will require the corporate sector to increase its research spending by roughly 145%, by 2010. That would require a compound annual growth rate of around 10.5%. Based on the current situation, sustaining this growth over the remainder of the decade will be a tall order. So, as things presently stand the government may have to extend its target by a few years.

The economic boom of the late 1990s gave many companies an enhanced taste for research. Evidence from Fiscal 2002 shows that a majority of firms are holding fast; they are reinforcing their ability to compete with new products and services when the economy turns around. Stay tuned for Fiscal 2003 results, which will tell us if they have turned the corner.

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