



Economics

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Peter Buchanan
(416) 594-7354
peter.buchanan@cibc.ca

Warren Lovely
(416) 594-8041
warren.lovely@cibc.ca

Andrew Grantham
(416) 956-3219
andrew.grantham@cibc.ca

Nick Exarhos
(416) 956-6527
nick.exarhos@cibc.ca

<http://research.cibcwm.com/res/Eco/EcoResearch.html>

Canadian Small Business — Economic Landscape

By Benjamin Tal, Andrew Grantham and Nick Exarhos

The common understanding is that a small business is a firm that is independently owned and managed by its owner or part owner in a personalized fashion, often resulting in greater dependence on outside sources for guidance. That makes little distinction between business and personal financial goals.

Statistics Canada often defines a small business as a firm with less than 50 full-time equivalent employees and, in some statistical publications, refers to small businesses as those having annual sales of less than \$2 million. None of these quantitative definitions are universally satisfactory. The available statistics in some cases are only rough approximations, while some overlap with the criteria for mid-size businesses cannot be avoided entirely.

Furthermore, these aggregate statistics failed to include the underground economy, which has been growing in recent years. Another problem of measuring small business activity is the fact that, although legally independent, many small businesses (particularly in the manufacturing sector) depend on one or a few clients and suppliers for the major part of their sales and production.

Nevertheless, there has recently been a notable improvement in the collection, analysis and distribution of information related to small business activity. Statistics Canada and Industry Canada have stepped up their efforts to improve our understanding of the economic behaviour

of this sector. While more work needs to be done, as the current information on small business is still not commensurate with the sector's importance, we are now better positioned to evaluate the dynamics behind small business economic behaviour.

Small businesses are most economically viable when:

- The burden of fixed assets and capital requirements is relatively light
- Products or services must be designed for a particular need or require specialized skill
- The introduction of new technology is either neutral with respect to economies of scale or makes economies of scale less relevant. The marketplace requires higher flexibility and speed to meet demand

At the same time, to varying degrees, most small businesses face the following weaknesses:

- Unsound or insufficient analysis in choosing an initial field of business
- Poor management skills
- Lack of economies of scale
- Inadequate capitalization

These weaknesses are inter-linked and largely explain the high level of failure among smaller firms. The lack of economies of scale means, in many cases, that the cost structure facing small business owners prevents them from maintaining a sufficient level of profitability. This, along with

inadequate capitalization, limits retained earnings growth and productivity improvements. In addition, the lack of sufficient market knowledge or management skills usually leads to a situation where a particular business is set up based on ease of entry into the field rather than on sound economic grounds.

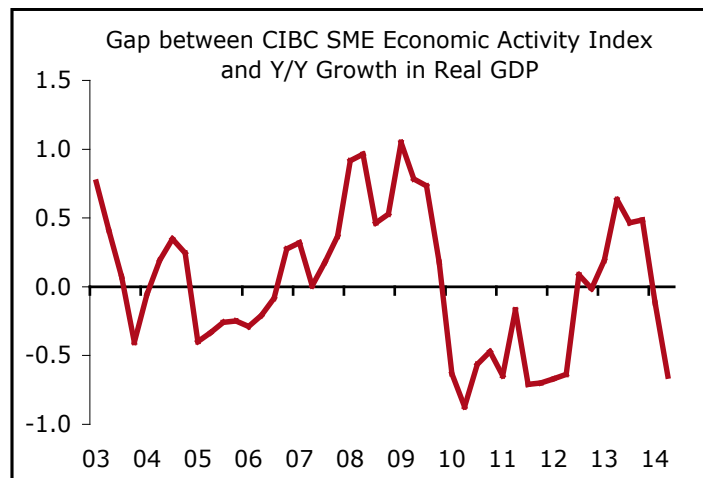
Small Business in the Current Recovery

The performance gap between small business economic activity and real GDP shows that the composition of growth has shifted away from favouring smaller enterprises (Chart 1). Our small business activity index is based on real GDP growth modified by allocating different weights to industries in a way that reflects small business activity in those sectors more accurately.

Looking back at the recent history, we see that small business activity outperformed the broader economy in the earlier part of the recovery. That's of course a function of those businesses' reliance on the consumer. With Canada's overvalued exchange rate weighing on their international competitiveness, and the financial crisis dampening foreign demand, larger enterprises with greater access to international markets were the ones who bore the brunt of a weak exit of the crisis. But with the consumer using home equity gains and cheap credit savings to spur spending, Small and Medium Enterprises (SMEs) benefited from their largely domestic focus.

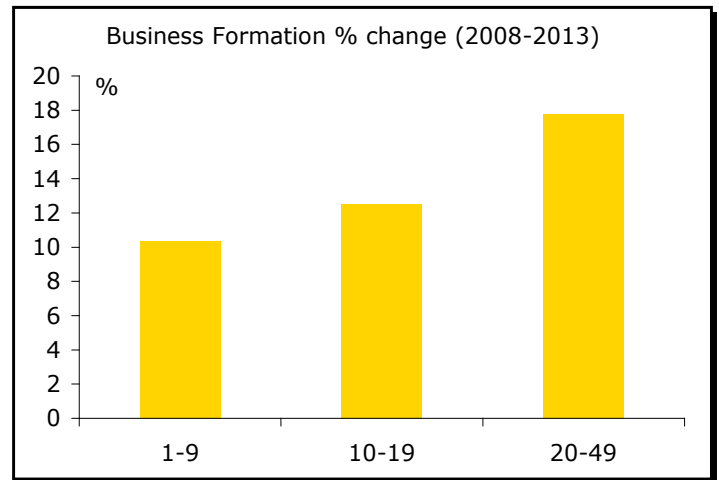
At the now, more-mature stage of the cycle things are changing and small businesses are the ones lagging the economy as a whole. Exports have been on the upswing,

Chart 1
Recent Economic Trajectory Less Favourable to SMEs



Source: Statistics Canada, CIBC

Chart 2
Small Businesses Are Getting a Bit SLarger



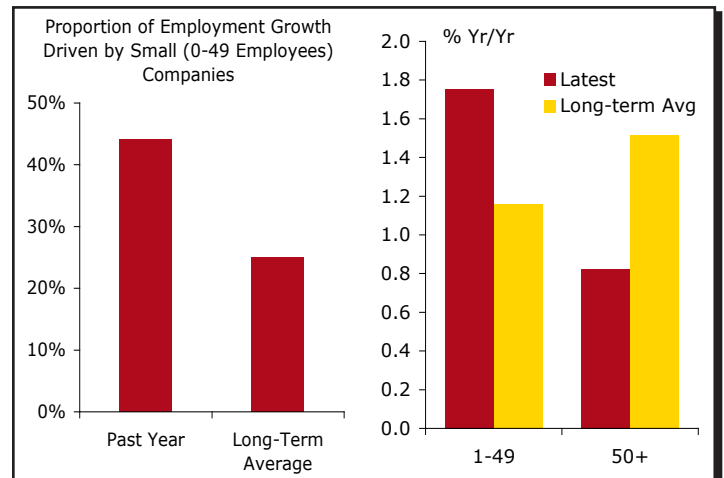
Source: Statistics Canada, CIBC

helped along the way by a meaningful drop in the C\$ below parity. Just as SMEs are less responsive to a rise in the value of the loonie, they are just as insensitive to C\$ weakness.

Since the recession small businesses are becoming a bit larger, that is the number of firms with 20-49 employees rose by close to 18%, those with 10-19 employees are up by 12.5%, while those with less than 10 employees rose by 10.3% (Chart 2).

And that's consistent with what we've been seeing in employment. Despite the fact that our small business index suggests economic conditions have deteriorated for

Chart 3
SMEs' Disproportionate Contribution to Employment



Source: Statistics Canada, CIBC

them recently, small businesses have been contributing a greater-than-normal share of hiring recently (Chart 3, left). That's partly because hiring in the rest of the economy has been muted. But small businesses have also been adding to their workforce at a greater rate than they have historically as well (Chart 3, right). Meanwhile the share of self-employment has been largely unchanged since 2000, despite declines in provinces tilted more heavily to sectors such as fishing and agriculture.

Does this mean that small businesses have a productivity problem? Could they be over-investing on payrolls but under-investing on fixed capital? Compared with other countries that have similar proportions of self-employed and small businesses, Canada certainly appears to be lagging somewhat in terms of GDP per hour worked (Chart 4, left).

However, we can't place the whole burden for that around the neck of small businesses. In fact, many have been very active in terms of investment. A previous Deloitte study showed that half of small businesses contributed around 85% of all small business investment (Chart 4, right).

But of course that leaves the other 50% of firms contributing only 15% of the money spent on investment. What's most interesting is that many of those weren't aware that they were investing less than others. 72% of firms in the study were described as "overconfident"—in other words thinking they were investing as much as others when they weren't (Chart 5, left).

Indications that financial conditions are loosening again could help those firms gain the credit they need to undertake such investment. Recent Industry Canada data highlight a healthy authorization rate for loans, and that once again fewer financial institutions are asking for collateral to be placed against small business loans (Chart 5, right).

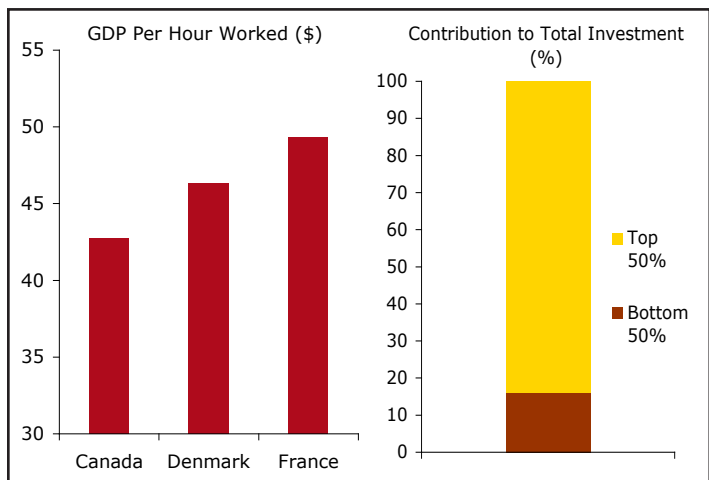
So there are clearly still opportunities out there for small businesses to exploit, particularly given structural factors that favour the launching and growing of new endeavours.

SMEs Future Role in the Canadian Economy

There are some environmental shifts that are making for fertile terrain for sprouting small businesses. We've all been made aware that the spoils of the current recovery haven't been as evenly distributed as prior instances. In many cases the rich have gotten richer. Higher-priced homes have gained in value more quickly than those more moderately priced, and low interest rates and aggressive monetary policy the world over have been supportive not only of bonds, but of equities and other alternative investment.

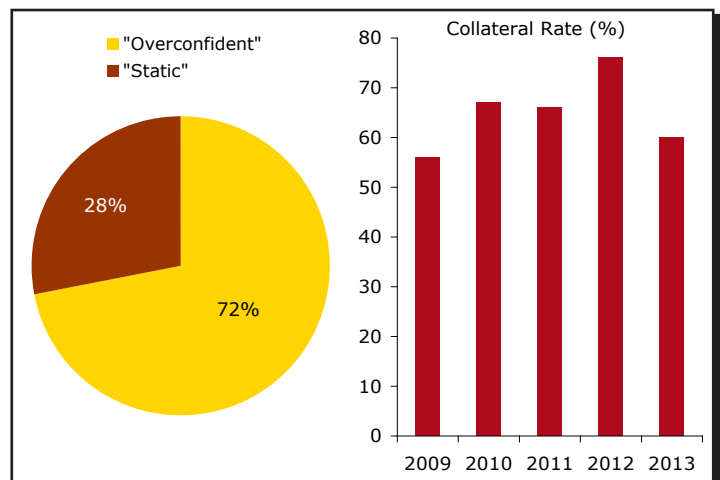
These avenues of income and wealth gains are not available to most. And they have not been accompanied by commensurate gains in wages. The upshot to that divergence is that demand for niche products and services has grown. That demand is often filled by specialized

Chart 4
Room for Canadian Small Business Productivity Gains (L), and Investment (R)



Source: OECD, Deloitte, CIBC

Chart 5
SMEs Overconfident on Investment Needs (L), But Loosening Credit Conditions Can Incentivize Them to Borrow (R)



Source: Deloitte, Industry Canada, CIBC

but small-scale operations, where dedicated craftspeople pursue entrepreneurial aspirations.

Aside from wealth effects, technological advances have made it easier for people to get their small businesses off the ground, and—once launched—facilitate rapid, more affordable, growth. Starting a company website, purchasing targeted online ad space, reading up on potential customers (and competitors) can be done in an afternoon with a computer and an internet connection. Increased connectivity will bring a higher level of cooperation between small business, self-employed, and larger firms. The theme here is that each participant provides a specific expertise as it relates to a specific project. This kind of cluster of competencies and strategic alliances will be temporary in nature and, at the end of a particular project, dissolve and may or may not cooperate again.

Those factors will no doubt also support small business external orientation, while also working to increase foreign competition in the products and services small firms both provide and purchase. This type of competition will put increasing pressure on small business in terms of price, quality, cost control, efficiency, marketing expertise, customer satisfaction and innovation. Moreover, the increased globalization of SMEs means that more and more new firms must export from their inception in order to be competitive. The implication is that in order to profit from globalization, these small firms will have to be able to penetrate new markets. This, in turn, is achievable only if these firms succeed in identifying niche markets.

Increased export and import orientation also points to greater complexity in doing business. Small business will have to be increasingly aware of trade, tax and other regulations in the countries with which they trade. Foreign exchange risk is another important factor to consider. It is not clear that small businesses in Canada are totally prepared to fully deal with the impact of globalization.

Given the current environment, we have determined the regions that are most likely to benefit from the projected structural increase in SME activity. We identified nine macro factors that in aggregate can help us to determine regional growth for SMEs in the coming five years:

Macro Factors

- Economic Growth — The extent to which the macro environment supports SME activity
- Urban/Rural Mix — The concentration of SMEs in large urban centres. Recent years have seen growth in SME formation in those areas outpace growth in rural areas
- Labour Availability — The share of firms citing labour shortages as a source of restraint on their operations
- Net Exports Position — The balance of exports minus imports, and a measure of sensitivity to the prospects of a weaker C\$
- Demographics — Growth in the 35-55 year-old age group. This age group has the highest propensity to become self-employed and start a business
- Net Migration — The contribution of new immigrants to growth in the labour force, with the motivation here that new immigrants have a higher tendency to become self-employed
- Sectoral Mix — The extent to which the fastest growing sectors in the economy are also SME-friendly
- Outsourcing Activity — The propensity by large corporations to outsource core activity
- Debt Position — A measure of dependence on financing and a proxy for sensitivity to higher interest rates

West is Best

For each province, we aggregated the findings and calculated a score which indicates relative prospects for SMEs in the coming five years. We then ranked the provinces according to their aggregate scores, with double the weight added to expected economic growth, given its importance (Table 1).

Our findings suggest that western provinces provide the greatest advantages for small businesses, with those in Atlantic Canada lagging behind.

The top-ranked province was Alberta, which scores well in several metrics. It has the strongest projected growth, while also possessing good demographics and immigration trends. Those latter characteristics offer a steady stream of future entrepreneurs and workers to drive operations in tomorrow's SMEs. The province does lack an advantage in export orientation, with a concentration in Alberta's outbound flows in larger, energy-focused firms.

Second on our list is British Columbia. There, strong provincial growth prospects, solid urban concentration

and labour dynamics suggest that smaller enterprises can exploit emerging opportunities. And if firms sprout up to align themselves with growing sectoral opportunities, it would shore up an area of weakness. There, a competitive position in firms' management of debt financing can be exploited to expand capacity and open business lines targeted towards areas of growth.

Ontario bases its third-place ranking on its superior integration in larger firms' production chains. But the province also has better-than-average demographics, and a solid base of available labour, giving SMEs the manpower they need to operate and grow. The province

isn't, however, aligned to industries poised to see the highest growth. It will need to work on its weaker readings on debt management to give firms the capital they need to expand toward industries with brighter prospects.

There's a three-way tie for fourth between Saskatchewan, Manitoba and Québec. Those provinces possess a combination of reasonably good access to credit, export orientation, and outsourcing integration. Aside from specific traits, those common themes mean that SMEs in those provinces are well aligned to capitalize on potential growth in external demand.

Table 1
Ranking the Provinces

	British Columbia	Alberta	Saskatchewan	Manitoba	Ontario	Quebec	New Brunswick	Nova Scotia	Prince Edward Island	Newfoundland and Labrador
Growth (2014-2018)	2	1	3	5	4	7	9	6	8	10
Urban	2	4	9	6	3	5	1	7	10	8
Labour Availability	3	6	7	5	2	4	1*	1*	1*	1*
Net Exports	6	7	5	3	4	2	1*	1*	1*	1*
Demographics	5	2	10	9	3	7	4	6	8	1
Immigration	4	3	2	1	5	7	8	9	6	10
Industry Orientation	10	7	1	3	9	5	8	6	2	4
Outsourcing Activity	T-5	4	T-5	T-5	1	2	3*	3*	3*	3*
Debt Position	3	4	2	5	7	1	6*	6*	6*	6*
Overall Rank**	2	1	T-4	T-4	3	T-4	7	8	9	10

*No disaggregated data available for Atlantic provinces

**Double the normal weight has been placed on growth

This report is issued and approved for distribution by (a) in Canada, CIBC World Markets Inc., a member of the Investment Industry Regulatory Organization of Canada, the Toronto Stock Exchange, the TSX Venture Exchange and a Member of the Canadian Investor Protection Fund, (b) in the United Kingdom, CIBC World Markets plc, which is regulated by the Financial Services Authority, and (c) in Australia, CIBC Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC") and (d) in the United States either by (i) CIBC World Markets Inc. for distribution only to U.S. Major Institutional Investors ("MII") (as such term is defined in SEC Rule 15a-6) or (ii) CIBC World Markets Corp., a member of the Financial Industry Regulatory Authority. U.S. MIIs receiving this report from CIBC World Markets Inc. (the Canadian broker-dealer) are required to effect transactions (other than negotiating their terms) in securities discussed in the report through CIBC World Markets Corp. (the U.S. broker-dealer).

This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets Inc. in Canada, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. This document and any of the products and information contained herein are not intended for the use of private investors in the United Kingdom. Such investors will not be able to enter into agreements or purchase products mentioned herein from CIBC World Markets plc. The comments and views expressed in this document are meant for the general interests of wholesale clients of CIBC Australia Limited.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgments as of the date of this report and are subject to change without notice.

This report may provide addresses of, or contain hyperlinks to, Internet web sites. CIBC has not reviewed the linked Internet web site of any third party and takes no responsibility for the contents thereof. Each such address or hyperlink is provided solely for the recipient's convenience and information, and the content of linked third-party web sites is not in any way incorporated into this document. Recipients who choose to access such third-party web sites or follow such hyperlinks do so at their own risk.

© 2014 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.