



ECONOMICS

Canadian SMEs: Strength Beneath the Surface

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Entrepreneurial activity is such a critical driver of Canada's economic growth that when the headline numbers suggest a cooling off, it's time to lift the hood and check the engine. The headlines suggest that activity at Canada's small- and medium-sized enterprises (SMEs) has been cooling down. And, certainly, self-employment has risen noticeably slower than paid-employment since the beginning of the decade. But, beneath the surface, small business activity in Canada is much stronger than perceived.

Growth in small business formation during the post-recession period was tilted toward larger operations with the number of small firms with employees rising faster than the number of single-person operations. What's more, the share of larger SMEs has risen to a level not seen in almost a decade. So yes, paid-employment is on the rise, but more

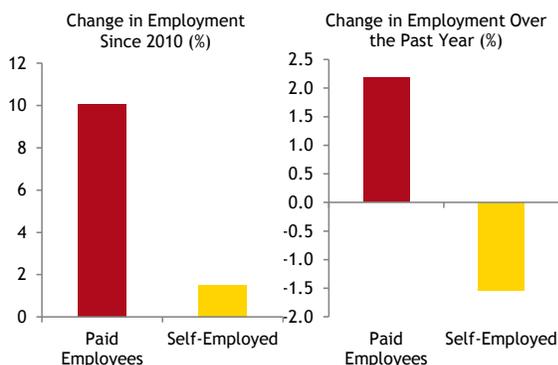
of those employees are working at SMEs. That compositional change is significant as it implies a higher multiplier effect from SMEs on the Canadian economy.

Small Businesses are Getting Bigger

While growth in self-employment has lagged recently (Chart 1), meaning that fewer Canadians have been going out on their own, that's far from a complete picture of entrepreneurship and small business activity.

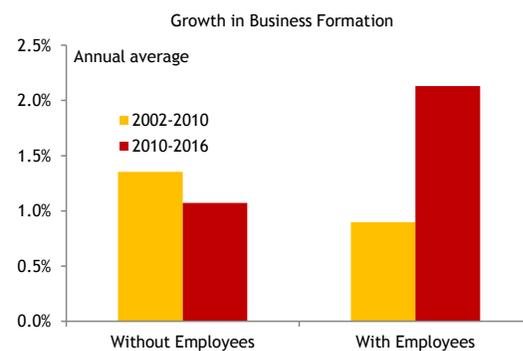
The number of companies without any employees has only grown modestly since 2010, but the growth of companies with employees has actually accelerated (Chart 2). Furthermore, it's not only that the number of firms with employees has been rising, it's also that small businesses with employees have in general been getting bigger.

Chart 1
Self-Employment Has Lagged Since the Crisis (L) And More Recently (R)



Source: Statistics Canada, CIBC

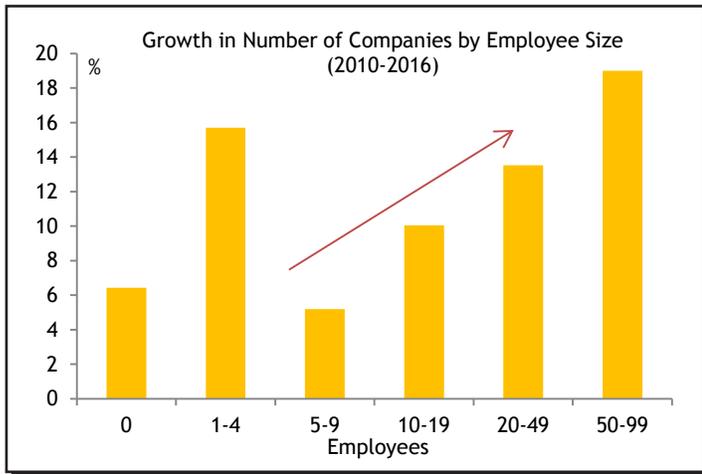
Chart 2
The Composition of the Business Formation is Changing



Source: Statistics Canada, CIBC

<http://economics.cibccm.com>

Chart 3
Small Business are Getting Bigger

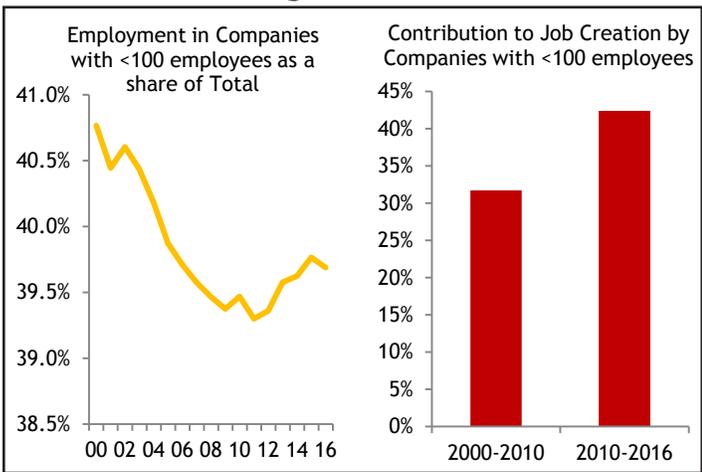


Source: Statistics Canada, CIBC

As illustrated in Chart 3, beyond the threshold of five employees, there is a clear positive correlation between size and growth. Larger firms within the SME spectrum have seen progressively stronger growth recently. Since the beginning of the decade, the number of SMEs with 20 employees or more has risen by an annual average rate of 2.5%, almost half a percentage point faster than the average of smaller companies. And, those with 50 or more workers have grown even faster. That's a stark difference from what was happening earlier in the millennium. Between 2000 and 2010, the number of SMEs with 50 or more employees declined in absolute and relative terms.

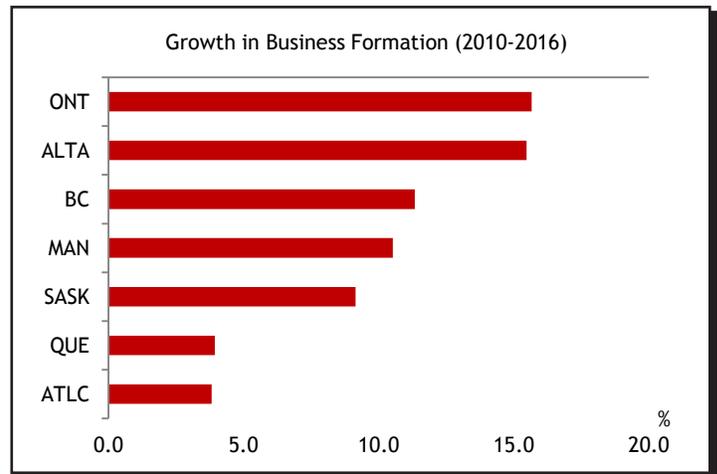
That change is also very evident in the labour market. Between 2000 and 2010 SMEs with less than 100

Chart 4
SMEs Increased Hiring



Source: Statistics Canada, CIBC

Chart 5
Shift Toward Businesses with Employees Has Been Evident West of Québec

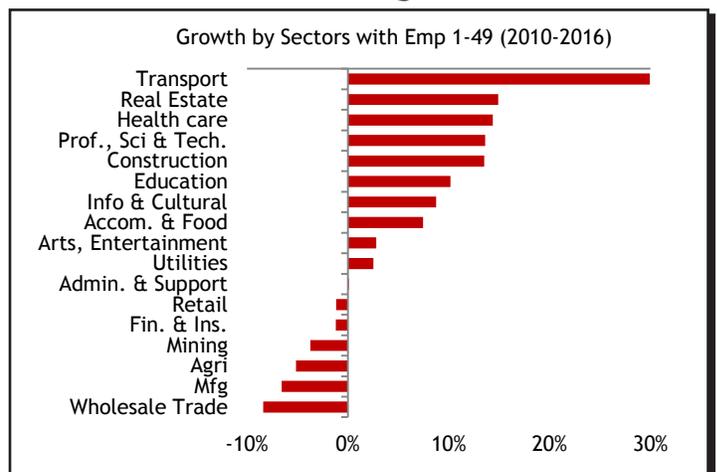


Source: Statistics Canada, CIBC

employees accounted for just over 30% of new jobs. Since then their contribution has risen to 42% (Chart 4).

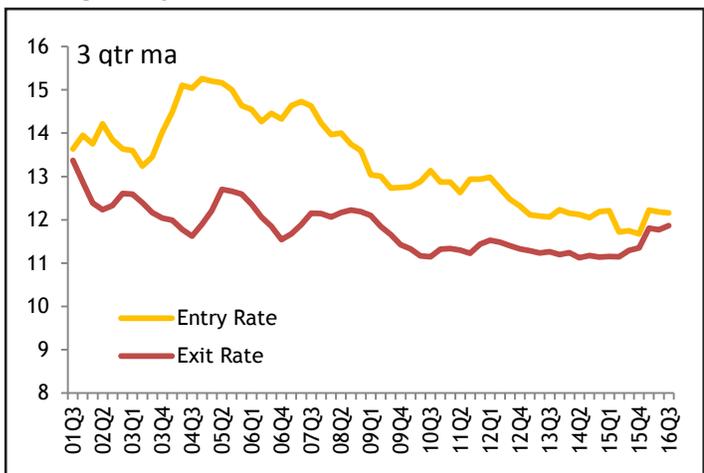
The compositional shift away from companies with no employees to those with many has been most evident west of Québec. Each province from Ontario to BC has exhibited a growth rate of more than 9% in the number of companies with employees (Chart 5). While on an industry basis, small businesses are trending further toward the services side of the economy. With the exception of construction, which has been boosted by the recent strength of the housing market, the top-performing industries have been moving with the tide of the rest of the economy, away from goods-producing sectors and toward services (Chart 6).

Chart 6
Small Businesses are Trending Towards Services



Source: Statistics Canada, CIBC

Chart 7
Falling Entry Rate, Stable Exit Rate



Source: Statistics Canada special tabulations, CIBC

The Tip of the Iceberg

But those numbers are just the tip of the iceberg as SME activity is much more dynamic than those numbers reveal. Last year for example, more than 350,000 businesses were created and just under 300,000 exited (Chart 7). That breakdown is useful as it provides more information about the dynamics of business formation in Canada.

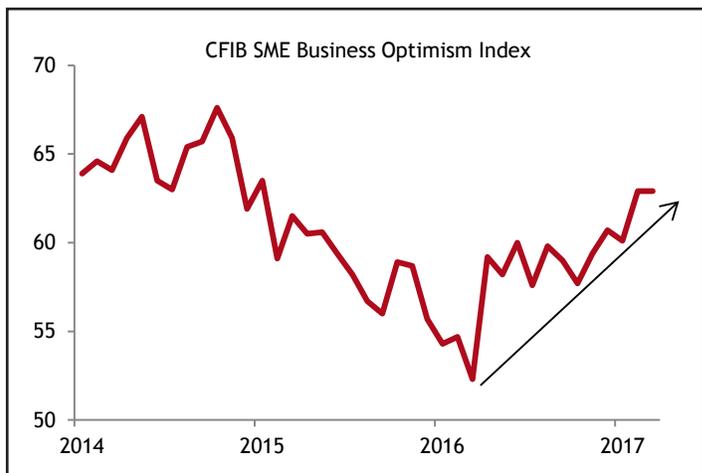
The entry rate (the ratio of business creation to total businesses) has seen a downward trend since 2004, clearly a disturbing trend. The exit rate has been more stable, with the recent uptick likely to be only temporary. The timing of the move higher in the exit rate coincided with the fall in oil prices a couple of years ago. Small business optimism has been grinding higher since bottoming out early last year and appears headed back to levels seen prior to the oil price shock (Chart 8).

Positive Backdrop

With the Canadian economy in recovery mode, the environment for small businesses remains constructive.

According to the World Bank, Canada is one of the best places to start a new business. The country is ranked second in terms of the environment for entrepreneurs. Canada’s score takes into account factors like the cost of starting a business, the capital required and the amount of time it takes.

Chart 8
Small Business Optimism is Recovering From the Oil Price Shock



Source: CFIB, CIBC

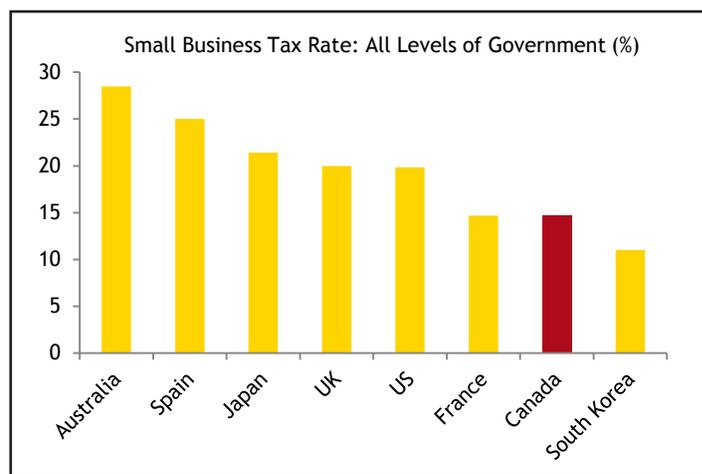
Furthermore, when compared to other developed countries, Canadian small businesses face a relatively favourable tax regime (Chart 9).

Canadian SMEs also generally don’t have many issues finding funding. A recent survey found that obtaining financing was actually the last thing standing in the way of SME investment this year (Chart 10).

Gaps That Can be Filled

All this is not to say that the small business environment in Canada is perfect. While financing is generally not an issue for most SMEs, it remains a headwind for a number

Chart 9
Small Businesses Have a Favourable Tax Rebate in Canada



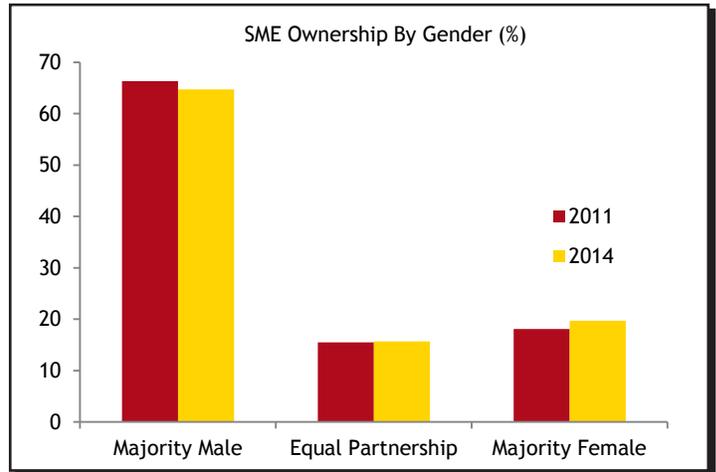
Source: OECD, CIBC

Chart 10
Financing is Not a Major Concern For Most SMEs



Source: BDC, CIBC

Chart 12
While the Workforce Has Made Progress, Female Entrepreneurship Lags



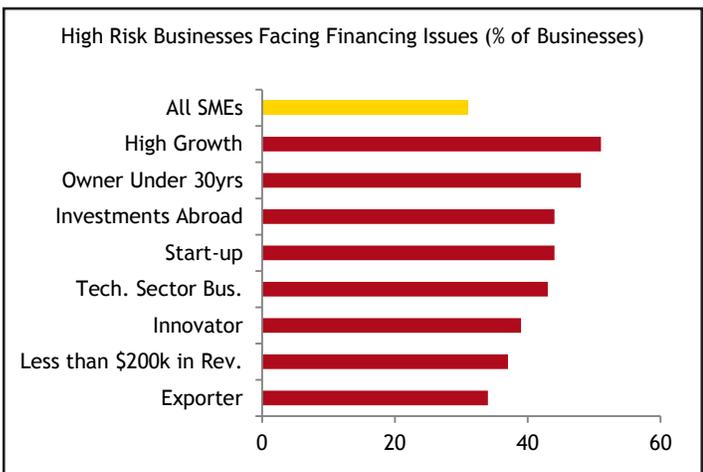
Source: Innovation, Science & Economic Development Canada

of high risk small businesses. From companies with high growth rates to those with young owners, some SMEs do face more acute issues finding financing (Chart 11).

The small business space could also benefit from more diverse ownership characteristics. Female participation in the workforce has made significant progress over the past few decades, but entrepreneurship remains an area that could see improvement. Female majority ownership in the SME space represents less than 20% of all businesses, and recent progress has been slow in coming (Chart 12). Females remain an untapped resource in the SME space.

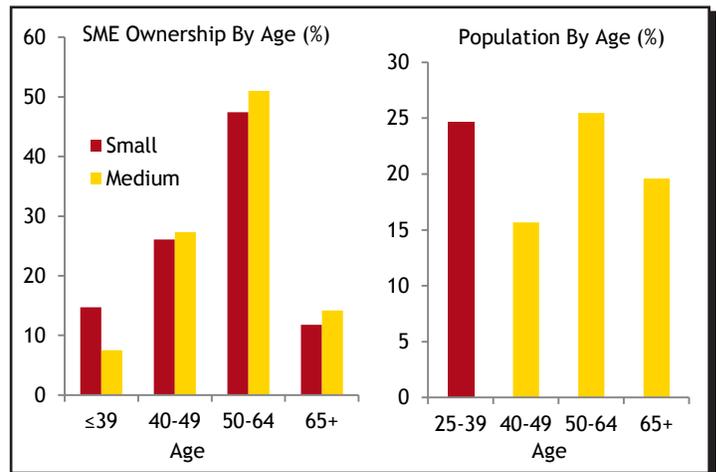
Youth entrepreneurship is also lagging. Young Canadians, between the ages of 25 and 39, make up almost a quarter of the adult population over 25. However, they represent less than 15% of small business owners and less than 10% of medium-sized business owners (Chart 13). One reason for this discrepancy could be related to their access to financing. Remember that companies with younger owners face much more difficulty when trying to externally fund their business. It will be important to watch this segment of the population as Canada tries to compete with other countries in the tech landscape, which is more tilted toward younger business owners than other industries.

Chart 11
For a Number of High Risk Businesses, Financing Remains a Headwind



Source: BDC, CIBC

Chart 13
So Does Entrepreneurship of Younger Canadians



Source: Innovation, Science & Economic Development Canada

As we've noted in previous publications, SME revenue continues to be geographically concentrated in North America, creating a unique risk. Currently, only around 10% of SMEs are involved in any sort of exporting at all, and roughly 90% of those companies are sending their wares to the US (Table 1). Diversification outside of Canada is important, but so too is looking beyond the

US. In the current political environment, it has become a risky proposition to focus solely on the US market. There is certainly room to increase the ratio of Canadian goods and services being exported to places like Asia and Latin America. The age of digital connection has made it much easier to send Canada's high-end service exports all over the world, something many SMEs could benefit from.

Table 1

Export Orientation of SMEs Remains Overly Reliant on the US

	US	Europe	China	Other Asia	Latin America
Agriculture & Mining	86	18	30	13	11
Construction	90	19	NA	0	NA
Manufacturing	96	31	12	16	19
Wholesale Trade	87	23	12	19	13
Retail Trade	95	31	8	6	16
Transportation & Warehousing	91	22	19	21	14
Prof., Sci. and Tech. Services	84	34	12	17	17
Other Services	92	11	0	NA	13
Info, Real Estate, Admin., Health, Arts, Rec.	85	47	11	14	22

Source: Innovation, Science & Economic Development Canada

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